Supreme Court, U.S.
FILED
98 145 JUL 16 1998
OFFICE OF THE CLERK

No. _____

In The

Supreme Court of the United States

October Term, 1997

BANKERS LIFE AND CASUALTY COMPANY,

Petitioner,

v.

UNITED STATES OF AMERICA,

Respondent.

On Petition For Writ Of Certiorari To The United States Court Of Appeals For The Seventh Circuit

PETITION FOR WRIT OF CERTIORARI

ROBERT F. FORRER
Counsel of Record
GARY H. KLINE
THOMAS E. CHOMICZ
WILSON & MCILVAINE
500 West Madison Street
Suite 3700
Chicago, IL 60661-2511
(312) 715-5000

Counsel for Petitioner

COCKLE LAW BRIEF PRINTING CO., (800) 225-6964
OR CALL COLLECT (402) 342-2831

106 pp

QUESTIONS PRESENTED

I

Whether a Court, having concluded that the literal language of an Internal Revenue Code provision is silent on the issue presented in analyzing an interpretive Treasury Regulation, may decline to analyze the provision's statutory context, design and structure to ascertain Congressional intent under the first step of *Chevron*.

II

Whether under I.R.C. § 815 non-cash assets distributed by a life insurance company are to be measured at their adjusted tax basis, thereby invalidating interpretive Treas. Reg. § 1.815-2(b)(3), which provides a different and inconsistent measure of such distributed assets.

PARTIES TO THE PROCEEDING

All the parties are named in the caption.

STATEMENT PURSUANT TO RULE 29.6

Bankers Life And Casualty Company is a corporation wholly owned by Bankers Life Insurance Company of Illinois, which, in turn, is a wholly owned subsidiary of CIHC, Inc., which is a wholly owned subsidiary of Conseco, Inc., a publicly traded company listed on the New York Stock Exchange. Bankers Life And Casualty Company has no nonwholly owned subsidiaries.

TABLE OF CONTENTS

Page

QUESTIONS PRESENTED i

PARTIES TO THE PROCEEDING ii

STATEMENT PURSUANT TO RULE 29.6..... ii

TABLE OF AUTHORITIES v

OPINIONS BELOW..... 1

JURISDICTION..... 1

STATUTORY AND REGULATORY PROVISIONS INVOLVED 2

STATEMENT OF THE CASE..... 2

REASONS FOR GRANTING THE PETITION 7

I. The Decision Below Conflicts With This Court's Decisions Establishing The Analytical Framework For Determining The Validity Of Treasury Regulations And Other Agency Regulations And Rules..... 8

II. As A Result Of Its Misapplication Of The *Chevron* Analysis, The Seventh Circuit Erroneously Affirmed The District Court's Judgment..... 13

CONCLUSION 17

APPENDICES

Page

Opinion of the United States Court of Appeals for the Seventh Circuit, dated April 17, 1998 .....A1

Judgment of the United States Court of Appeals for the Seventh Circuit entered on April 17, 1998 .....A37

TABLE OF CONTENTS – Continued

Page

Memorandum Opinion and Order of the United States District Court for the Northern District of Illinois, Eastern Division dated March 22, 1996 ...A38

Judgment In A Civil Case entered by the United States District Court for the Northern District of Illinois, Eastern Division on March 22, 1996.....A63

Section 802 of the Internal Revenue Code of 1954, as amended A64

Section 815 of the Internal Revenue Code of 1954, as amended A66

Treasury Regulation § 1.815-2 .....A78

TABLE OF AUTHORITIES

Page

CASES

Atlantic Mutual Ins. Co. v. Commissioner, 118 S. Ct. 1413 (1998) 8, 10, 11

Brown v. Gardner, 513 U.S. 115 (1994) 11

Chevron U.S.A. Inc. v. National Resources Defense Council, Inc., 467 U.S. 837 (1984) ..... *passim*

Dole v. United Steelworkers of America, 494 U.S. 26 (1990) 12

Fulman v. United States, 434 U.S. 528 (1978) 10

Imperial General Life Ins. Co. v. Commissioner, 60 T.C. 979 (1973) 6

K-Mart Corp. v. Cartier, Inc., 486 U.S. 281 (1988) 12

MCI Telecomm. Corp. v. American Tel. & Tel. Co., 512 U.S. 218 (1994) 12

Regions Hosp. v. Shalala, 118 S. Ct. 909 (1998) 11

STATUTES

28 U.S.C. § 1254(1) (1988) 1

28 U.S.C. § 1346(a)(1) (1988 & Supp. IV 1992) 2

28 U.S.C. § 2101(c) (1988) 1

REGULATIONS

Treasury Regulation § 1.815-2(b)(3) (1961) ..... *passim*

TABLE OF AUTHORITIES – Continued

Page

OTHER AUTHORITY

I.R.C. § 346 (1982) (amended 1988)..... 6

I.R.C. §§ 802 (1982) (repealed 1984)..... *passim*

I.R.C. § 815 (1982) (amended 1988)..... *passim*

I.R.C. § 7805(a) (1982) (amended 1988 & Supp. IV 1992).....3, 13

Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 211, 98 Stat. 494, 720 (1985) 2

PETITION FOR WRIT OF CERTIORARI

Bankers Life And Casualty Company (hereinafter "Bankers Life") respectfully petitions for a writ of certiorari to review the judgment and opinion of the United States Court Of Appeals For The Seventh Circuit in this case.

OPINIONS BELOW

The opinion of the Seventh Circuit is reported at 142 F.3d 973 and is set forth in its entirety in the Appendix hereto at A1. The memorandum opinion and order of the United States District Court for the Northern District of Illinois, Eastern Division, affirmed by the Seventh Circuit, is unreported and is available on Westlaw as, *Bankers Life And Casualty Company v. United States*; 1996 WL 137646, 79 A.F.T.R.2d 97-1726, and is set forth in its entirety in the Appendix hereto at A38.

JURISDICTION

The decision below was issued by the Seventh Circuit on April 17, 1998 and judgment was entered on that date. Bankers Life did not file a petition for rehearing in the Seventh Circuit. In accordance with 28 U.S.C. § 2101(c) (1988), this Petition is filed within ninety days of the date on which the judgment was entered. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1) (1988).

STATUTORY AND REGULATORY PROVISIONS INVOLVED

The relevant statutory provisions which applied during the relevant period, I.R.C. §§ 802, 815 (1982) and Treas. Reg. § 1.815-2(b)(3) are set forth in their entirety in the Appendix hereto at A64, A66 and A78, respectively.

STATEMENT OF THE CASE

1. Proceedings Below

Bankers Life, a stock life insurance company, filed a three-count complaint against the United States of America in August, 1993 for refund of federal income taxes and interest as allowed by law with respect to its 1983 and 1984 tax years. Jurisdiction in the District Court was based upon 28 U.S.C. § 1346(a)(1) (1988 & Supp. IV 1992). The case was submitted to the District Court on stipulated and unopposed facts and both parties moved for summary judgment. The District Court denied Bankers Life's motions for summary judgment and granted Respondent's cross-motions for summary judgment on all counts. Bankers Life appealed as to two of the counts and, during the pendency of the appeal, the parties settled one of those counts.

The remaining substantive issue before the Seventh Circuit was whether, under then § 815 of the Internal Revenue Code,[1] Bankers Life's 1983 distribution of non-

[1] All sections referenced are to the Internal Revenue Code of 1954, as amended, and as in effect during the relevant period. The section at issue here is a part of Subchapter L, which was substantially amended by the Deficit Reduction Act of 1984

cash real property to its shareholder was to be measured for purposes of the so-called Phase III federal income tax by the adjusted tax basis or the fair market value of those non-cash assets. Treas. Reg. § 1.815-2(b)(3), issued pursuant to the general grant of authority in § 7805(a) (1982) (amended 1988 & Supp. IV 1992) of the Internal Revenue Code, expressly required a fair market value measure. Bankers Life contended that certain of the language of § 815, coupled with its context and the statutory structure of § 815, and the underlying tax accounting principles embodied in that structure, evidenced Congress's intent that adjusted tax basis be the measure and that, therefore, the Regulation was invalid.

2. The Seventh Circuit's Decision And Opinion

In affirming summary judgment in favor of Respondent, the Seventh Circuit held that, because in its view the literal wording of § 815 was "silent" (A34) on the issue of the proper measure for the distributed assets, it must defer to the Regulation if the Regulation's result had "some colorable support." (A35) The Seventh Circuit, in so limiting its analysis, chose not to analyze Bankers Life's arguments as to the context, design and structure of § 815 to determine first whether Congress itself had spoken to the applicable measure for the distributed assets. Rather, it relegated those arguments to the second step of its analysis and then only in the context of whether those arguments "robbed" the Regulation of its reasonableness. (A34)

(Pub. L. No. 98-369, § 211, 98 Stat. 720). I.R.C. § 802 was repealed and some of its language merged with I.R.C. § 801.

The Seventh Circuit so held notwithstanding its conclusion that this Court's decision in *Chevron U.S.A. Inc. v. National Resources Defense Council, Inc.*, 467 U.S. 837 (1984) provided the analytical framework within which the Regulation's validity was to be determined.

3. Internal Revenue Code Sections 802 And 815 And The Regulation

Commencing in 1959 and throughout the relevant period, Congress allowed stock life insurance companies to defer from federal income taxation one-half of their annual underwriting gains. The rationale for this deferral was that, in view of the contingent nature of life insurance claims, such deferred amounts constituted an appropriate cushion or reserve against long-term contingencies.

As part of the statutory structure providing this deferral, Congress also developed a tax accounting system which was designed to determine when the deferral of such underwriting gain would end and when the so-called Phase III federal income tax with respect to such previously deferred income would become payable. The foundation of this tax accounting system was the maintenance by each life insurance company of two tax memoranda accounts which corresponded to two general types of income.

The tax memoranda account known as the policyholders surplus account ("PSA"), from a tax accounting standpoint, reflected the life insurance company's undistributed deferred underwriting income. The other account, the shareholders surplus account ("SSA"), from a tax accounting standpoint, reflected undistributed amounts that had already been taxed to the life insurance

company or were not taxable to the life insurance company in the first instance.

The amounts in each of these tax memorandum accounts were accounted for (credited) at their adjusted tax basis. Therefore, these tax memoranda accounts did not include or reflect the unrealized appreciation in the value of any of the life insurance company's investment assets.

Under then I.R.C. § 815(a), a triggering event for the end of the deferral was a distribution to shareholders, which distribution was first "treated as" made "out of" the SSA and then, to the extent of any excess, was "treated as" made "out of" the PSA. (A66) Any such subtraction from the PSA released into taxable income on a dollar-for-dollar basis the deferred underwriting income reflected in the PSA, which, under I.R.C. § 802(a)(1) and (b)(3) became subject to the so-called Phase III tax (which in effect was the "regular" corporate tax applied on a deferred basis to the deferred underwriting income). (A64-65) The underlying structure of this tax accounting system reflected the principle that a distribution should not end the deferral if the distribution did not change the fact that amounts at least equal to the deferred underwriting income continued to be retained and continued to function as a reserve or cushion against long-term contingencies.

After the expiration of the notice and comment period, Treas. Reg. § 1.815-2(b)(3) was issued and published in the Federal Register in January, 1961. Prior to

this case, the Regulation's validity had never been adjudicated and had been referenced in only one reported judicial opinion.[2] The Regulation was never amended.

4. Undisputed Facts

The parties stipulated to the following undisputed relevant facts. During 1983, Bankers Life distributed substantial real estate and real estate-related assets to its sole shareholder, the John D. and Catherine T. MacArthur Foundation, a charitable foundation, pursuant to a partial liquidation under I.R.C. § 346 (1982) (amended 1988). These distributed assets had an aggregate adjusted tax basis of $209,650,747 and an aggregate fair market value in excess of $875,000,000 – that is, these distributed assets had unrealized appreciation of over $666,000,000. In 1983, Bankers Life had a SSA of $241,014,695 and a PSA of $154,434,319. If the aggregate adjusted tax basis were the proper measure of the distribution and if, accordingly, the unrealized appreciation element of the distribution were not a subtraction from the SSA and PSA, then Bankers Life would have had no reduction in its PSA and, therefore, no 1983 Phase III income and no 1983 Phase III tax liability.

Bankers Life, in accordance with Treas. Reg. § 1.815-2(b)(3), initially treated fair market value as the measure of the distribution and, therefore, recognized the full amount of its PSA as Phase III income. Subsequently,

---

[2] In the sole case that referenced Treas. Reg. § 1.815-2(b)(3), *Imperial General Life Ins. Co.* v. *Commissioner*, 60 T.C. 979 (1973), the Tax Court specifically noted that the taxpayer had not challenged its validity.

Bankers Life timely filed a claim for refund based on its belief that the Regulation was invalid and that the correct measure of the 1983 non-cash distribution for purposes of calculating the charge to Bankers Life's SSA was the distributed assets' adjusted tax basis. This refund claim was disallowed.[3]

REASONS FOR GRANTING THE PETITION

This case provides this Court with the timely opportunity to provide the lower courts with clear direction as to the proper application of the *Chevron* two step analysis in cases involving interpretive Treasury Regulations and, indeed, in all cases involving a challenge to the validity of a regulation issued by a department or agency.

The first question presented relates to the fundamental nature and scope of the required analysis in determining whether, under *Chevron's* first step, Congress has spoken to the particular issue. According to the Seventh Circuit, an examination of the underlying statutory design, structure and context is not part of that analysis. In so holding, the Seventh Circuit has abandoned the settled province and duty of the judiciary to say what the law is. Furthermore, the Seventh Circuit has so broadly defined the second step of the *Chevron* analysis as to

---

[3] Pursuant to the aforementioned partial settlement, the parties agreed that Bankers Life's recovery is now limited to interest for ten months on the 1983 Phase III tax it paid plus interest on such interest as allowed by law.

make a finding of regulation invalidity virtually impossible. The Seventh Circuit's decision, therefore, should be reviewed not merely to correct an erroneous decision but also to re-establish promptly the vital role of the judiciary in determining the validity of an agency's or department's regulations.

I

The Decision Below Conflicts With This Court's Decisions Establishing The Analytical Framework For Determining The Validity Of Treasury Regulations And Other Agency Regulations And Rules.

In *Chevron*, this Court established a two part analytical framework to be used by courts in determining the validity of a regulation. The first step requires, in addition to reviewing the literal language of the statute, an examination of the context in which the statutory language was enacted and the design and structure of the statute to determine first whether Congress has spoken to the particular issue. Only *after* a court has so analyzed the context, design and structure of the statute and only *after* it has concluded that Congress did not speak to the issue presented, may a court then apply the second part of the *Chevron* test; that is, whether "the agency's answer is based on a permissible construction of the statute." 467 U.S. at 843.

Subsequent to *Chevron*, a controversy described by the Seventh Circuit as a "free-fire zone of judicial debate," ensued over whether the two part *Chevron* analysis applied to interpretive Treasury Regulations. (A9) That question was resolved this term in *Atlantic Mutual*

Ins. Co. v. Commissioner, 118 S.Ct. 1413 (1998) wherein this Court cited *Chevron* as supplying the required first step analytical framework in an interpretive Treasury Regulation validity case. Bankers Life had so contended throughout this litigation. The Seventh Circuit ultimately agreed. (A21-23)

The Seventh Circuit, however, *applied* that analysis in a manner which conflicts not only with *Chevron* itself but also with this Court's decisions in numerous post-*Chevron* cases. These decisions reiterate that the first step includes an intensive examination of the context in which the statutory language was enacted and its underlying statutory structure and design to determine whether Congress has spoken to the particular issue.

The Seventh Circuit began its *Chevron* analysis by acknowledging its own ambivalence over the scope of the first step (A24), and by then concluding that the Seventh Circuit "seem(s) to lean toward" reserving consideration of legislative history and "other appropriate factors" (such as the design of the statute as a whole) to the second step. (A24) It then held:

> With that said, however, we reiterate *Chevron's* fundamental dictate that a court must not "substitute its own construction of a statutory provision for a reasonable interpretation" by the agency in question. (A25) (emphasis added)

In doing so, the Seventh Circuit quoted language from *Chevron* having no bearing on this Court's application of the first step in *Chevron*. 467 U.S. at 844.

This misreading of *Chevron* led the Seventh Circuit into its primary error – limiting its first step inquiry

solely to whether the literal wording of § 815 spoke to the issue of the proper measure of the amount of a non-cash assets. Citing this Court's pre-*Chevron* decision in *Fulman v. United States*, 434 U.S. 528 (1978), the Seventh Circuit held:

> Even more fundamentally, the plain language of the statute simply fails to address the question of valuation. In other words, the statute is silent on this question. In *Fulman*, the Supreme Court faced a similar situation in which "while obviously some rule of valuation must be applied, Congress . . . failed expressly to provide one." 434 U.S. at 533. Here, too, Congress failed to expressly provide a method of valuation. Because the statute is silent, we should not attempt to infer a method of valuation under the guise of determining the plain meaning of the provision. (A34)

As a result, the Seventh Circuit examined Bankers Life's arguments as to the structure and design of § 815 solely in the context of determining, under the second step of the *Chevron* test, whether these arguments "robbed" the Regulation of its reasonableness (A34) rather than in the context of whether the plain meaning of the underlying statutory provisions required adjusted tax basis as the proper measure of a distribution.

This abbreviated *Chevron* first step stands in stark contrast to this Court's analysis in *Atlantic Mutual*, decided shortly after the Seventh Circuit's decision in this case. In *Atlantic Mutual* this Court, noting that the statutory term "reserve strengthening" was not defined in the Code, nonetheless explored whether its "plain meaning" could be discerned either from its having an established

meaning in the property-casualty industry or from the term's prior use in life insurance tax legislation. Only after concluding that neither industry usage nor prior legislation provided the "plain meaning" advanced by the taxpayer did the Court proceed to the *Chevron* second step; that is, whether the Treasury Regulation represented a reasonable interpretation of the statute. 118 S.Ct. at 1417-1418.

The Seventh Circuit's approach is also inconsistent with this Court's decisions applying *Chevron* in non-tax cases. In these cases, this Court has repeatedly undertaken a thorough examination of the language, context, design and structure of the statute at issue in order to determine, first, whether Congress had spoken to the issue.

For example, in *Regions Hosp. v. Shalala*, 118 S.Ct. 909 (1998), this Court referred to the "now familiar" formulation of the *Chevron* test and its required use by the courts of traditional tools of statutory construction to first determine Congress' intent, including an examination of other provisions of the statute and focusing on the relevant context.

In *Brown v. Gardner*, 513 U.S. 115 (1994), this Court reiterated that the meaning of statutory language, plain or not, depends on context. This Court in this case undertook a detailed analysis of the language of the particular section of the Veterans Administration Act, dictionary definitions, the context of that language, textual cross references to other parts of the Act and consideration of the "incongruity" in the application of words. Ultimately this Court held that "the text and reasonable inferences

from it give a clear answer against the Government and that, as we have said is, 'the end of the matter.' " *Id.* at 556.

So too in *MCI Telecomm. Corp. v. American Tel. & Tel. Co.*, 512 U.S. 218 (1994), this Court in resolving the parties' dispute over the meaning of the phrase "modify any requirement" in § 203(b)(2) of the Telecommunications Act underscored that the meaning should be discerned not simply from dictionary definitions but also from contextual indications. *Id.* at 227. This Court also took into account the enormous importance to the "statutory scheme" of the tariff filing provision at issue. The Court ultimately concluded: "But our estimations, and the Commission's estimations, of desirable policy cannot alter the meaning of the Federal Communications Act of 1934."

In *Dole v. United Steelworkers of America*, 494 U.S. 26 (1990), this Court emphasized that with respect to a challenge to a regulation, the reviewing court must first "try to determine congressional intent, using traditional tools of statutory construction." *Id.* at 35. This Court then went on to state that in addition to focusing on the statutory language a court must look to the structure of the underlying statutory scheme and "the provisions of the whole law, and to its object and policy." *Id.* at 35 [quoting from *Massachusetts v. Marsh*, 490 U.S. 107 (1989) and *Pilot Life Insurance Co. v. Oedeaax*, 481 U.S. 41, 51 (1987).]

In *K-Mart Corp. v. Cartier, Inc.*, 486 U.S. 281 (1988), this Court emphasized that in determining whether a challenged regulation is consistent with the statute it implements, the reviewing court must ascertain the statute's plain meaning by looking to the particular statutory

language at issue and the language and design of the statute as a whole. *Id.* at 291.

In erroneously applying an abbreviated first step of *Chevron*, the Seventh Circuit eschewed this Court's directives as to the role of the judiciary in reviewing agency and department regulations and so expansively defined the second part of the *Chevron* test as to make a finding of regulation invalidity a virtual impossibility. Such an expansive view of "judicial deference" not only establishes an erroneous precedent in the Seventh Circuit but also adds further confusion as to the correct application of the *Chevron* analysis. Prompt correction of this error is of particular importance in cases addressing the validity of Treasury Regulations which repeatedly require resolution of the tension between Congress' power to tax and to establish tax policy and its I.R.C. § 7805(a) directive to the Treasury Department to adopt "all needful rules and regulations for the enforcement of" the income tax provisions of the Code.

Because of its misapplication of the two step *Chevron* analysis, the Seventh Circuit erroneously upheld the validity of Treasury Regulation § 1.815-2(b)(3) and affirmed the judgment of the District Court.

II

As A Result Of Its Misapplication Of The *Chevron* Analysis, The Seventh Circuit Erroneously Affirmed The District Court's Judgment

Throughout the proceedings below, Bankers Life consistently advanced several distinct arguments which, when applied under the *Chevron* first step, evidenced

Congress' intent that the adjusted tax basis measure be utilized for non-cash distributions under § 815. Those arguments centered around the statutory language of § 815, fundamental principles of tax accounting that are consistently applied throughout the Internal Revenue Code, certain fundamental principles that are embodied in the statutory scheme, legislative history and consistency of results.

These arguments included, among other arguments, the following:

1. Treas. Reg. § 1.815-2(b)(3) was inconsistent with the distribution "out of" language of § 815. An element, such as unrealized appreciation, could not be distributed "out of" the SSA or PSA if it had never been included or reflected in the SSA or PSA.

2. The underlying statutory provisions established a debits and credits tax accounting system. A debits and credits system of accounting inherently embodies the rule that there must be uniformity between debits and credits – that is, debits and credits must be based on or reflect the same measure and an item cannot be a debit item in a tax accounting system if the item cannot be a credit item. Because credits to the SSA and PSA corresponded to, and reflected, adjusted tax basis, distributions, which constituted debits to these accounts, must also reflect adjusted tax basis and not fair market value as required by the Regulation. Because the unrealized appreciation element of the distributed assets was not a credit to the SSA or the PSA, the distribution of this element could not have been a debit to these accounts.

3. The effect of interjecting the Regulation's fair market measure into the Phase III tax accounting system was to create a result which was in direct conflict with the following underlying principles which were embodied in the statutory Phase III tax accounting system:

> (a) The underlying statutory scheme ensured that if a distribution did not change the fact that amounts at least equal to the deferred underwriting income continued to be retained and continued to function as a reserve or cushion against long-term contingencies, the deferral would not end.
>
> (b) The underlying statutory scheme ensured that items that should not be taxed – because such items had previously been taxed or were not taxable in the first instance – would not be subject to the Phase III deferred tax and would not be a trigger event for the Phase III tax. (The unrealized appreciation of the distributed assets was an item that was not taxable in the first instance.)

The Seventh Circuit rejected the first argument in its first step *Chevron* analysis largely on the basis of its construction of the "treated as" language in § 815 without examining the reasons, based on the underlying statutory structure, that the "treated as" language had to be included in § 815.

In analyzing Bankers Life's second argument, based on settled tax accounting principles inherent throughout the Code, the Seventh Circuit in applying the second step of *Chevron*, concluded:

> And Bankers Life certainly demonstrates that the regulation conflicts with the methods of conventional taxation. But conflicts do not equal irrationality. The IRS may adopt regulations that produce unusual results, so long as those results have some colorable support. As *Chevron* itself explained, an agency may choose among conflicting policies. *See* 467 U.S. at 845. Furthermore, as the government argues, because of the singularity of the Phase III system, any conflicts with regular taxation do not mean very much. (A35) (emphasis added)

Neither the Seventh Circuit nor Respondent cited any authority – linguistic, legislative or otherwise – that Congress intended § 815 to be interpreted in a manner that would conflict with methods of conventional taxation that were embodied throughout the Code and in the Phase III system. The Seventh Circuit, rather than considering such inconsistency as a primary, if not determinative, factor in discerning Congress' intent as to the measure of a distribution under the first part of the *Chevron* analysis, brushed the conflict aside under the second part of the *Chevron* analysis as "not being equal (to) irrationality." (A35)

The Seventh Circuit did not even address the third argument set forth above based on cardinal principles that were embodied in the underlying statutory structure and design.

By granting this petition, this Court will be positioned to correct the Seventh Circuit's underlying decision, and this Court will be able to nip in the bud the Seventh Circuit's entirely erroneous view that statutory

context, design, and structure are not relevant to the application of the first part of the *Chevron* analysis.

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be granted.

Dated: July 15, 1998

Respectfully submitted,

ROBERT F. FORRER
Counsel of Record
GARY H. KLINE
THOMAS E. CHOMICZ
WILSON & MCILVAINE
500 West Madison
Suite 3700
Chicago, IL 60661-2511
(312) 715-5000

Counsel for Petitioner

APPENDIX

In the
United States Court of Appeals
for the Seventh Circuit

No. 96-2260

BANKERS LIFE AND CASUALTY COMPANY,

Plaintiff-Appellant,

v.

UNITED STATES OF AMERICA,

Defendant-Appellee.

Appeal from the United States District Court
for the Northern District of Illinois, Eastern Division.
No. 93 C 4739 – **Paul E. Plunkett,** *Judge.*

ARGUED FEBRUARY 20, 1998 – DECIDED APRIL 17, 1998

Before CUMMINGS, KANNE, and EVANS, *Circuit Judges.*

EVANS, *Circuit Judge.* Upon first glance, this lawsuit seems overly ambitious. Bankers Life and Casualty Company invites us to invalidate a seemingly straightforward and long-standing Treasury regulation. The insurance company's bold argument makes sense in light of one crucial fact: Bankers Life seeks a tax refund of *$71 million* plus interest from 1983. In effect, Bankers Life is betting on a long shot. It must know its chances of winning are slim, but the huge potential payoff apparently justifies the effort.

In a nutshell, Bankers Life attacks the validity of Treasury Regulation § 1.815-2(b)(3). The regulation had been on the books for 22 years – since the end of the Eisenhower Administration – at the time it was applied to Bankers Life. The regulation measured the value of a life insurance company's distribution of real property to its shareholders according to market value – rather than adjusted basis – for the purpose of determining whether the distribution triggered a tax on previously untaxed income. The district court, after upholding the validity of the regulation, granted summary judgment in favor of the government, and Bankers Life, on this appeal, asks us to reverse the judgment.

As one might expect in a case involving the interpretation of the tax code and its accompanying regulations, a certain amount of dry exposition is necessary to lay out the controversy. This story begins with the death of John D. MacArthur, the owner of Bankers Life and Casualty, in 1978. MacArthur's death invoked the terms of a trust agreement that transferred ownership of the insurance company to the John D. and Catherine T. MacArthur Foundation (a name well-known to public television and radio audiences). In 1983, because of legal limits on the foundation's ability to hold corporate stock, *see* I.R.C. § 4943(c)(6), the insurance company transferred some of its real estate holdings to the foundation as a distribution to the sole shareholder. Eventually, in 1984, the foundation divested itself of Bankers Life by selling the company to the ICH Corporation. This case focuses on the amount of tax owed by Bankers Life because of the 1983 distribution of real estate assets. The fair market value of these real estate holdings was a whopping *$875*

million. Their aggregate adjusted tax basis, however, was just under *$210 million*. The difference between the two valuations results in a $71 million tax differential.

The distribution invoked the arcane rules for taxation of life insurance company income. *See United States v. Atlas Life Ins. Co.*, 381 U.S. 233, 235 n.2 (1965) (describing the life insurance taxation system); *Continental Bankers Life Ins. Co. v. Commissioner*, 93 T.C. 52, 60 (1989) (same). For our purposes, matters are even more obscure because Congress changed these rules in 1984.[1] *See* Tax Reform Act of 1984, Pub. L. No. 98-369, §§ 211-24, 98 Stat. 494. In any event, under these complex rules, life insurance companies paid taxes in three distinct "phases." Under "Phase I" taxation, an insurance company paid a tax on the lesser of either its gain from investment or its gain from investment and underwriting. *See* I.R.C. § 802(b)(1). Under "Phase II" taxation, an insurer paid taxes on *one-half* of the amount by which the gain from underwriting exceeded the gain from investment. See I.R.C. § 802(b)(2). In effect, Phases I and II taxed the insurance company's income – except for the remaining *one-half* of the gains from underwriting. This remaining income received special deferred taxation – "Phase III" taxation – the general subject of this case. The law required the insurance company to keep a running tally of this Phase III income and to pay a tax on the money when the company issued certain distributions to its shareholders. *See* I.R.C. § 802(b)(3).

---

[1] Thus, unless otherwise noted, all citations to the Internal Revenue Code and Treasury regulations are to the statutes and regulations in effect in 1983 – namely, the 1954 I.R.C.

In order to keep track of the Phase III income and determine when it owed taxes on the money, the revenue code required insurance companies to maintain two sets of bookkeeping entries, or, in IRS parlance, "tax return memorandum accounts." The first of these accounts – the "shareholders surplus account" ("SSA") – recorded the amount of accumulated after-tax earnings from Phase I and II income. *See* I.R.C. § 815(b). The second account – the "policyholders surplus account" ("PSA") – recorded the amount of accumulated Phase III income. *See* I.R.C. §§ 802(b)(3), 815(c).

The laws allowed an insurance company to distribute its Phase I and II after-tax earnings to its shareholders without consequence. Accordingly, whenever a life insurer issued a distribution, it deducted the amount of the distribution from the SSA without tax consequences. This made complete sense because the company already paid Phase I and II taxes on this money. If, however, the distribution exceeded the amount of money recorded in the SSA, the laws treated the excess amount of the distribution as a transfer of Phase III income and required the insurance company to pay Phase III taxes. Thus, the insurer deducted the excess from the PSA and paid a Phase III tax on this amount. *See* I.R.C. § 815.[2]

---

[2] Strictly speaking, the 1984 tax reforms did not abolish all remnants of the three-phase structure. The new laws grandfathered existing PSA accounts. The 1984 statutes mandated that life insurers maintain existing PSA accounts, *see* I.R.C § 815(d) (1984), and pay a tax on "the amount of direct and indirect distributions . . . to shareholders from such account," *see* I.R.C. § 815(a)(2) (1984).

To sum up, a life insurance company could have distributed its after-tax earnings (the amount of money in the SSA) without paying any additional tax. But when the company dipped into the previously untaxed earnings (the amount of money in the PSA) to make a distribution, it paid the Phase III income tax. In other words, the laws allowed the life insurance company simply to avoid paying taxes on a big chunk of its income until it distributed that income to the shareholders.

Why did life insurance companies receive this unusual treatment?[3] The Senate Finance Committee discussed the matter when it enacted the Life Insurance Company Income Tax Act of 1959 which established the three-phase tax structure. *See* Pub. L. No. 86-69, 73 Stat. 112. According to the committee report, Phase III taxation addressed the "long-term nature of life insurance contracts" by allowing the company to keep one-half of the annual underwriting gain as "a desirable 'cushion' for special contingencies which may arise." S. Rep. No. 86-291, at 26 (1959). The report explained that underwriting gains may appear as income under an annual tax system when, in fact, these gains merely serve to fulfill life insurance contracts down the road. *See id.; see also* H.R. Rep. No. 86-34, at 1, 15 (1959). The special deferred tax treatment adjusted for the conflict between a tax code

---

[3] The three-phase tax structure was not really a special deal won by effective lobbying. On the contrary, the scheme enacted a total income approach – taxing revenues from both investment and underwriting. Previously, life insurers paid taxes only on investment revenue. *See* S. Rep. No. 86-291, at 20-21 (1959).

based on annual income and the timetable of the insurance business in which income remains uncertain until actuarial predictions come to life (or death, as the case may be).

Congress reasoned that when a life insurance company made a distribution so large that it dipped into the PSA, then the company no longer needed a big reserve for a rainy day. As the Senate committee explained, "If the insurance company itself decides to distribute these amounts to stockholders, it has demonstrated that this cushion is no longer needed." S. Rep., *supra*, at 26. Thus, a distribution larger than the SSA triggered the Phase III tax.

So far, we have explained one part of the mechanism the IRS used to calculate Phase III taxes. We still need more information to determine the amount of tax. The missing link is the method for valuing the distribution. To determine the value of a distribution for purposes of Phase III taxation, the IRS relied on a regulation – Treasury Regulation § 1.815-2(b)(3) – developed under its general authority to promulgate necessary rules. *See* I.R.C. § 7805(a). Before issuing this regulation, the IRS followed full notice and comment procedures. Treasury Regulation § 1.815-2(b)(3) provided that certain noncash distributions would be measured by fair market value:

> Except in the case of a distribution in cash and as otherwise provided herein, the amount to be charged to the special surplus accounts referred to in subparagraph (1) of this paragraph with respect to any distributions to shareholders (as defined in section 815(a) and paragraph (c) of this section) shall be the fair

> market value of the property distributed, determined as of the date of distribution. However, for the amount of the adjustment to earnings and profits reflecting such distributions, see section 312 and the regulations thereunder. For a special rule relating to the determination of the amount to be charged to such special surplus accounts in the case of a distribution by a foreign life insurance company carrying on a life insurance business within the United States, see section 819(c)(1) and the regulations thereunder.

If we put some real world numbers to all of this abstract tax talk we can see why Bankers Life has a bone to pick with the IRS. In 1983 Bankers Life had an SSA of $241,014,695 and a PSA of $154,434,319. The real estate assets it distributed to the foundation, as we noted earlier, had a fair market value of over $875 million but an aggregate adjusted basis of only $209,650,747. Pursuant to Treasury Regulation § 1.815-2(b)(3), Bankers Life valued the distribution at fair market value. As a result, the life insurance company depleted its SSA and emptied its PSA – paying Phase III taxes on the entire amount of the PSA. After computation of various adjustments, Bankers Life ended up paying a Phase III tax of $70,750,058.

Incidently, another abstruse twist in the tax laws prevented the IRS from just requiring Bankers Life to pay Phase I and II taxes on the distribution under the normal rule that when a corporation distributes appreciated property to shareholders, the corporation must recognize the gain. That obscure convolution in the tax code was the *General Utilities* doctrine (from *General Utilities & Operating Co. v. Helvering*, 296 U.S. 200 (1935)) – "was" because Congress extinguished the doctrine with the 1986

tax reforms. *See* Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085. The *General Utilities* doctrine provided that a corporation did not pay normal tax on a *noncash* distribution. Bankers Life made sure that this exception to the norm applied – it sought and received a private letter ruling that the 1983 distribution did not give rise to a taxable event for purposes of Phase I or Phase II taxation. *See* Private Letter 8540070 (July 10, 1985). (Bankers Life also received permission from Illinois regulators to make the distribution as an "extraordinary dividend" under state insurance law.) If Bankers Life had followed the current tax law regarding noncash distributions, it would have paid Phase I and II taxes on the appreciation, then included the after-tax gain in the SSA as a credit, and simultaneously entered a debit reflecting the full value of the distribution to the foundation.

In any event, Bankers Life predictably examined the enormous Phase III tax payment very closely. Not surprisingly, the company concluded that Treasury Regulation § 1.815-2(b)(3) conflicted with the tax code. Bankers Life argues that the tax code required the IRS to value distributions at aggregate adjusted basis – rather than fair market value – for purposes of calculating Phase III tax. According to Bankers Life, the IRS should have valued the distribution at just under $210 million, an amount lower than the balance of the SSA. The SSA would have absorbed the entire distribution and Bankers Life would not have deducted any amount from the PSA. Thus, under this approach, Bankers Life would have owed no Phase III tax at all.

Consequently, Bankers Life filed for a refund seeking a return of the Phase III tax plus interest since 1983. The

IRS stood by its regulation and disallowed the claim. Bankers Life then filed this lawsuit. Because the parties did not dispute the facts, the district court (Judge Paul E. Plunkett) needed to determine only the validity of Treasury Regulation § 1.815-2(b)(3). On March 22, 1996, Judge Plunkett upheld the regulation and granted summary judgment in favor of the government. Bankers Life now appeals. We review *de novo*. *See Bell Fed. Sav. & Loan Ass'n v. Commissioner*, 40 F.3d 224, 226 (7th Cir. 1994).

Before explaining Bankers Life's substantive arguments or the government's responses, we need to cover the basic structure of a challenge to a tax regulation. Essentially, we must determine the degree of deference owed to a Treasury Regulation issued under I.R.C. § 7805(a) with notice and comment procedures. This seemingly simple inquiry leads us into a free-fire zone of judicial debate over the proper level of judicial deference to various IRS interpretations of the revenue laws. The basic question is whether Chevron deference (from *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984), and its progeny) applies to tax regulations. *See, e.g., Central Pa. Sav. Ass'n v. Commissioner*, 104 T.C. 384, 390-91 (1995) (discussing the "checkered career" of *Chevron* deference in the tax arena), *supplemented by*, 71 T.C.M. (CCH), 1996 WL 165489 (Apr. 10, 1996). In addition to the debate in the case law, the topic has generated heated scholarly commentary. *See* Ellen P. Aprill, *Muffled Chevron: Judicial Review of Tax Regulations*, 3 Fl. Tax Rev. 51 (1996) (describing and advocating a fusion of *Chevron* and *National Muffler*, 440 U.S. 472 (1979)); Paul L. Caron, *Tax Myopia Meets Tax Hyperopia: The Unproven Case of Increased Judicial Deference to Revenue Rulings*, 57 Ohio St. L.J. 637

(1996) (critiquing attempts to apply discrete levels of deference to tax interpretations); John F. Coverdale, *Court Review of Tax Regulations and Revenue Rulings in the Chevron Era*, 34 Geo. Wash. L. Rev. 35 (1995) (arguing for distinct levels of non-*Chevron* deference for each type of tax interpretation); Linda Galler, *Judicial Deference to Revenue Rulings: Reconciling Divergent Standards*, 56 Ohio St. L.J. 1037 (1995) (attempting to provide a hierarchy of uniformly applied levels of deference for tax interpretations).

Unfortunately, we walk into this melee without very much help from the parties. Bankers Life inexplicably urges us to evaluate its challenge to Treasury Regulation § 1.815-2(b)(3) under what many commentators would consider the highly deferential *Chevron* standard. Frustratingly, the government neglects to address the applicability of *Chevron* deference. Therefore, before resolving this issue, we need some background information on the different forms of IRS interpretation and the corresponding degrees of deference.

The IRS interprets the tax code in four significantly different ways: (1) regulations issued pursuant to a specific directive from Congress, (2) regulations issued under the IRS's general authority to interpret the tax laws, (3) revenue rulings, and (4) private letter rulings. Each of these categories often receives different deference from the courts. While the first three categories constitute interpretations of general applicability, letter rulings apply only to the parties who specifically request them. Neither the courts nor the IRS may rely on letter rulings as precedent. *See* I.R.C. § 6110(j)(3) (1988); Treas. Reg.

§ 301.6110-7(b) (West 1998); *cf. Fox Valley & Vicinity Constr. Workers Pension Fund v. Brown*, 897 F.2d 275, 280 n.2 (7th Cir. 1990) (*en banc*). At the other end of the spectrum from letter rulings are regulations issued under specific grants from Congress. The tax code contains a myriad of specific congressional instructions regarding rulemaking. *See* Coverdale, *supra*, at 52 (estimating the number of specific grants at over 1000 and providing examples). Pursuant to the Administrative Procedures Act ("APA"), the IRS issues these rules with full notice and comment. *See* 5 U.S.C. § 553 (1994). In the middle, between letter rulings and specific authority regulations, are general authority regulations and revenue rulings. The IRS issues general authority regulations under its power to "prescribe all needful rules and regulations." *See* I.R.C. § 7805(a) (1994). While the IRS takes the position that regulations issued solely under this general authority do not require notice and comment, the agency nevertheless usually follows full notice and comment procedures. *See First Chicago NBD Corp. v. Commissioner*, ___ F.3d ___, 1998 WL 28113, *2 (7th Cir. Jan. 28, 1998). In contrast, the IRS does not follow notice and comment procedures for revenue rulings. Revenue rulings typically contain the IRS's interpretation of how the law applies to a set of hypothetical facts. Revenue rulings do not have broad application like regulations, but the IRS does consider them authoritative and binding. *See* Rev. Proc. 95-1, § 2.05 (codified at Treas. Reg. § 601.201 (West 1998)); Rev. Proc. 89-14, § 7.01 (codified at Treas. Reg. § 601.601 (West 1998)).

Revenue rulings receive the lowest degree of deference – at least in this circuit. In *First Chicago*, we held that

revenue rulings deserve "some weight," ___ F.3d ___, 1998 WL 28113, at *2, and are "entitled to respectful consideration, but not to the deference that the *Chevron* doctrine requires in its domain," *id.* at *1 (citations omitted). In other circuits this question has generated inconsistent rulings ranging from *Chevron* deference to no deference. *See* Coverdale, *supra*, at 81-84 (citing cases); Galler, *supra*, at 1059-74 (citing cases).

Determining the level of deference accorded to regulations is more difficult. Initially it may appear that we can resolve the problem by resorting to the APA's distinction between legislative and interpretive regulations. *See* 5 U.S.C. § 553(b)(3)(A) (1994). Administrative law scholars usually treat legislative regulations as rules of full legal effect – they create new legal duties binding on the parties and the courts and, therefore, require full notice and comment procedures. Interpretive rules, on the other hand, only clarify existing duties and do not bind; thus, they do not require notice and comment. In the tax world, however, these terms and classifications seem to provide more confusion than clarity. Tax experts refer to specific authority regulations as "legislative" and to general authority regulations as "interpretive." The confusion arises because the "interpretive" designation does not mesh with the characteristics of the IRS's general authority regulations. While the IRS calls its general authority regulations interpretive, the agency promulgates them according to the same formal procedures it employs for its specific regulations. Moreover, both the specific authority and general authority regulations, create duties and have binding effect. *See* Aprill, *supra*, at 55-56; Coverdale, *supra*, 48-50.

If this legislative versus interpretive distinction held up for tax regulations, we could apply the simple rule described in *Hanson v. Espy*, 8 F.3d 469 (7th Cir. 1993). In that case, we explained the distinction between nontax legislative and interpretive regulations and said that *Chevron* applied to legislative regulations only. *See id.* 472 n.3. General tax regulations seem to carry the force of law, they are developed according to notice and comment, and they have the imprimatur of a congressional delegation of authority. In substance, general tax regulations fall short of being full legislative regulations only because the congressional delegation is general rather than specific. This distinction, however, may not have any effect at all on the standard of deference because *Chevron* itself dealt with a regulation promulgated under an arguably general grant of authority to the EPA under the Clean Air Act. *See* Coverdale, *supra*, at 50. Furthermore, *Chevron* stated that its framework applied to implicit congressional delegations as well as to specific and explicit directives. *See Chevron*, 467 U.S. at 844.[4]

In any event, courts uniformly give tremendous deference to regulations issued under a specific directive from Congress. In fact, some courts give these regulations the same force as statutes, focusing only on whether the

---

[4] *Chevron* arguably, therefore, altered the understanding of a line of Supreme Court cases often applied to "interpretive" tax regulations. *See National Muffler Dealers Ass'n v. United States*, 440 U.S. 472 (1979); *Rowan Co. v. United States*, 452 U.S. 247 (1981); *United States v. Vogel*, 455 U.S. 16 (1982). These cases all distinguished between regulations issued under specific grants of authority (full deference) and regulations issued under general grants of authority (less deference).

agency promulgated the regulation properly within its scope of authority. *See* Coverdale, *supra*, at 53 (citing cases). We basically follow the same approach. In *Gehl Co. v. Commissioner*, 795 F.2d 1324 (7th Cir. 1986), we explained that "a court's main focus in examining a legislative regulation issued under a specific statutory authority 'is whether the interpretation or method is within the delegation of authority.' " *Id.* at 1329 (quoting *Rowan Co. v. United States*, 452 U.S. 247, 253 (1981)). One commentator suggests that this level of deference accords even greater respect to the IRS's views than *Chevron*. *See* Coverdale, *supra*, at 55. We leave that hypothesis for another day.

Where then does all of this leave tax regulations promulgated under general authority? The question would be easier if the IRS did not employ notice and comment rulemaking procedures – in other words, if general authority tax regulations more truly resembled interpretive regulations. In *Atchison, Topeka and Santa Fe Railway v. Pena*, 44 F.3d 437 (7th Cir. 1994) (*en banc*), *aff'd. without discussion, Brotherhood of Locomotive Engineers v. Atchison, Topeka and Santa Fe Railway*, 516 U.S. 152 (1996), we held that courts should accord only moderate deference to interpretive regulations issued without notice and comment by an agency without general rulemaking powers.[5] *See id.* at 442; *see also Central Midwest Interstate*

---

[5] Because *Atchison* dealt with a regulation issued by an agency that lacked an express authorization – either general or specific – to promulgate rules, it seems unlikely that general authority tax regulations would fall under *Atchison*'s rule of moderate deference.

Low-Level Radioactive Waste Comm'n v. Pena, 113 F.3d 1468, 1473 (7th Cir. 1997) ("we do not apply *Chevron*'s 'rubber stamp' to interpretive rules"). As the *Atchison* court explained:

> Whatever degree of deference due these interpretive rules is dictated by the circumstances surrounding the agency's adoption of its statutory interpretation. "The weight given to an agency interpretation depends on many factors, including the validity of its reasoning, its consistency with earlier and later agency pronouncements and whether the administrative document was issued contemporaneously with the passage of the statute being interpreted." *Doe v. Reivitz*, [830 F.2d 1441, 1447 (7th Cir. 1987), *amended*, 842 F.2d 194 (7th Cir. 1988)]. In short, we look to "the thoroughness, validity, and consistency of the agency's reasoning." *Orrego v. 833 West Buena Joint Venture*, 943 F.2d 730, 736 (7th Cir. 1991) (citing *United States v. Markgraf*, 736 F.2d 1179, 1184 (7th Cir. 1984)).

Atchison, 44 F.3d at 442.

In accord with its emphasis on the "circumstances surrounding the agency's adoption" of the regulation, the *Atchison* court understood *Chevron* either to apply or not to apply based on the extent to which an agency follows full notice and comment rulemaking procedures. The court explained that the notice and comment process provides a critical component in our decision to grant *Chevron* deference:

> The principal rationale underlying [*Chevron*] deference is that in this context the agency acts as a congressional proxy; Congress develops the statutory framework and directs the agency to

> flesh out the operational details. But Congress typically does not permit the agency to run free in this endeavor; the Administrative Procedures Act establishes certain procedures that the agency must follow. Chief among them is the notice-and-comment provision of the APA. 5 U.S.C. § 553. This rule-making process bears some resemblance to the legislative process and serves to temper the resultant rules such that they are likely to withstand vigorous scrutiny. It is this process that entitles the administrative rules to judicial deference.

Id. at 441-42.

In this regard *Atchison* is not unique. For instance, in *Pennington v. Didrickson*, 22 F.3d 1376 (7th Cir. 1994), we explained "[w]e are mindful of our obligation to defer to the interpretation of the agency whenever that interpretation can be said to embody a deliberate and considered interpretation of the legislative intent." *Id.* at 1383. When an agency undertakes notice and comment procedures it elevates the status of a regulation above mere interpretation. Similarly, in *Doe v. Reivitz*, 830 F.2d 1441, 1446-47 (7th Cir. 1987), *amended*, 842 F.2d 194 (7th Cir. 1988), we characterized regulations promulgated with the full panoply of procedures as "high powered" rules meriting *Chevron* deference. Thus, in this circuit it appears that rules developed pursuant to notice and comment procedures constitute full legislative regulations.

So, is there an answer to the question of whether we give *Chevron* deference to general authority tax regulations promulgated with notice and comment? At first it might appear that we shut the door on that question in *Bell Federal Savings & Loan Ass'n v. Commissioner*, 40 F.3d

224, 226 (7th Cir. 1994). Unfortunately, that case does not provide definitive closure.

In *Bell Federal* we considered an IRS regulation promulgated under the general authorization statute, I.R.C. § 7805(a), just like the regulation in this case. We weighed whether to apply *Chevron* deference (as the Sixth Circuit did in *Peoples Federal Savings & Loan Ass'n v. Commissioner*, 948 F.2d 289, 304-05 (6th Cir. 1991)) or whether to apply a more narrow traditional rule of deference to tax regulations (as the Ninth Circuit did in *Pacific First Federal Savings Bank v. Commissioner*, 961 F.2d 800, 805-08 (9th Cir. 1992)). The *Bell Federal* court opted for the traditional rule apparently because it was more narrowly tailored to tax regulations:

> The proper test for the validation of a challenged regulation thus requires only that the regulation issued by the Commissioner constitute a reasonable implementation of Congress's mandate. The Commissioner's interpretation need not be the only, or even the most, reasonable interpretation possible as "[t]he choice among reasonable interpretations is for the Commissioner, not the courts."

40 F.3d at 227 (quoting *National Muffler Dealers Ass'n v. United States*, 440 U.S. 472, 488 (1979)). *Bell Federal* continued by explaining that courts should inquire into whether the regulation " 'harmonizes with the plain language of the statute, its origin, and its purpose.' " *Id.* (quoting *National Muffler*, 440 U.S. at 477).

Bell Federal's choice of the traditional rule appeared eminently reasonable at the time. In *Cottage Savings Ass'n v. Commissioner*, 499 U.S. 554, 560-61 (1991), the Supreme

Court conspicuously did not cite *Chevron* and appeared to apply the traditional rule of tax deference: "Because Congress had delegated to the Commissioner the power to promulgate 'all needful rules and regulations for the enforcement of [the Internal Revenue Code],' 26 U.S.C. § 7805(a), we must defer to his regulatory interpretations of the Code so long as they are reasonable." *Id.* at 560-61 (citing *National Muffler*).

The *Bell Federal* court equivocated, however, on whether there was any real difference between *Chevron* and the traditional rule. *Chevron* upholds a regulation if the agency based its interpretation on a permissible construction of a statute, *see* 467 U.S. at 843, while the traditional rule validates the regulation if the agency reasonably implemented Congress's mandate. Noting that "both approaches apply essentially the same test," the *Bell Federal* court stated that "the difference between these two approaches is negligible at best – any regulation which is 'based upon a permissible construction' of an ambiguous statute will almost always 'implement the congressional mandate in some reasonable manner' and vice versa. . . . " 40 F.3d at 227.

While *Bell Federal*'s hedging about the difference between *Chevron* and the traditional rule gives us pause, we hesitate to apply the traditional rule for another reason. We think that the *en banc* decision in *Atchison* reopened the door that *Bell Federal* seemed to have shut. As Chief Judge Posner stated in *First Chicago*, "we consider [*Chevron*'s] application to interpretive rules issued by the Treasury to be open in this circuit, since the Treasury has decided to use the notice and comment procedure for interpretive rules, though not required to

do so by statute." ___ F.3d at ___, 1998 WL 28113, at *2 (citation omitted).

Atchison explained that the notice and comment procedure was the sine qua non for *Chevron* deference.[6] Because the IRS promulgates general authority regulations through a notice and comment process, *Atchison* militates forcefully in favor of according *Chevron* deference to those regulations. Thus, after *Bell Federal*, *Atchison* altered the balance and tipped the scales in favor of *Chevron*.[7]

---

[6] Having described the fundamental importance of notice and comment procedures, we note that courts could employ other standards. In *American Medical Ass'n v. United States*, 688 F. Supp. 358 (N.D. Ill. 1988), *aff'd. in part and rev'd in part*, 887 F.2d 760 (7th Cir. 1989), the district court eschewed a brightline rule and proposed distinguishing between legislative and interpretive regulations based on whether the regulation defined or gave "substantive content to language undefined in the Code." *Id.* at 364. Under this test, "the existence or nonexistence of a precise statutory definition of the term later elaborated on by the Treasury Regulation would mark the watershed." *Id.* Thus, this district court advocated an examination of "the nature of the reglation [sic], and not merely the source of authority for its promulgation." *Id.* at 365 (citing *Chamber of Commerce v. OSHA*, 636 F.2d 464 (D.C. Cir. 1980)). Other courts have observed that an agency's interpretation deserves diminished deference when it carries the indicia of a litigating position. *See Pennington*, 22 F.3d at 1383. *But cf. Amoco Corp. v. Commissioner*, ___ F.3d ___, 1998 WL 105480, at *9 (7th Cir. Mar. 11, 1998) (explaining that the court should consider a regulation "promulgated through notice-and-comment rulemaking" even if the rule "bears the marks of a litigating position.").

[7] We note the use of the traditional rule in *Indianapolis Life Insurance Co. v. United States*, 115 F.3d 430, 436 (7th Cir. 1997).

Furthermore, we think *Bell Federal*'s description of a "negligible" difference between the approaches might overstate the true extent of the divergence. *Chevron* held that "a court may not substitute its own construction of a statutory provision for a reasonable interpretation made by the administrator of an agency." 467 U.S. at 844. While the two approaches articulate the level of deference differently, they both come down to one operative concept – reasonableness. Thus, *Chevron* and the traditional rule constitute two different formulations of a reasonableness test. There may be some subtle difference in the phrasing of each framework, but we should be wary of attempts to discern too many gradations of reasonableness. As we explained in *Boyce v. Fernandes*, 77 F.3d 946 (7th Cir. 1996), "human ability to make fine distinctions is limited." *Id.* at 948 (describing the difficulty in distinguishing between the inquiries into a police officer's probable cause for an arrest and whether that officer receives qualified immunity). Viewed from this perspective at least, the supposed gap between *Chevron* and the traditional rule is a distinction without a difference.

The Tax Court shares our suspicion that *Chevron* merely repackages the traditional rule: "[W]e are inclined to the view that the impact of the traditional, i.e., *National Muffler* standard, has not been changed by *Chevron* but has merely been restated in a practical two-part test with subtle distinctions as to the role of legislative history and the degree of deference to be accorded to a regulation." *Central Pa. Sav. Ass'n v. Commissioner*, 104 T.C. 384 (1995),

---

The *Indianapolis Life* court, however, did not weigh the applicability of *Chevron* or the effect of *Atchison*.

supplemented by 71 T.C.M. (CCH), 1996 WL 165489 (Apr. 10, 1996). Thus, as one might expect, other circuits and the Tax Court apply *Chevron* to general authority tax regulations. *See, e.g., Western Nat'l Mut. Ins. Co. v. Commissioner,* 65 F.3d 90, 93 (8th Cir. 1995); *Redlark v. Commissioner,* 106 T.C. 31, 38-39 (1996).

This all leads us to the $64,000 question: If the deference test walks like *Chevron* and talks like *Chevron,* why shouldn't we just call it *Chevron*? Or, phrased differently, if the two standards are the same, does our denomination make any difference? Our answer lies with consistency. While we do not doubt that "foolish consistency is the hobgoblin of little minds, adored by little statesmen and philosophers and divines," Ralph Waldo Emerson, *Self Reliance,* Essays: First Series (1841), we hope that our emphasis on consistency does not qualify as foolishness. On the contrary, consistency in the law forms the backbone of effective jurisprudence. *See, e.g., Piper Aircraft Corp. v. Wag-Aero, Inc.,* 741 F.2d 925, 937 (7th Cir. 1984) (Posner, J., concurring) ("The most important function of appellate review is to maintain the consistency of the law; if consistency is not a desideratum, the argument for appellate review is weakened."). Because the APA imposes uniform procedures on agencies that formulate rules, there is some incentive for courts to apply a uniform framework for challenges to regulations developed with notice and comment. A consistent approach might help alleviate the tensions evident in the now-resolved conflict between the Sixth Circuit and the Tax Court over *Chevron. See Peoples Fed. Sav. & Loan Ass'n v. Commissioner,* 948 F.2d 289, 304-05 (6th Cir. 1991) ("[W]e conclude that the Tax Court used the wrong standard to decide this

case. Entirely ignoring *Chevron* . . . the Tax Court employed the standard in *National Muffler Dealers* which seemed to allow a plenary review of the legislative history without the deference requirements found in *Chevron*. . . . "). More practically, our decision signals an effort to move toward a resolution of the current circuit split on the issue. Currently the Sixth Circuit accords *Chevron* deference to all tax regulations. *See Peoples Federal*. Meanwhile, the Third and Fifth Circuits have rejected Chevron for general authority tax regulations. *See E.I. du Pont de Nemours & Co. v. Commissioner*, 41 F.3d 130, 135-36 & n.23 (3d Cir. 1994); *Nalle v. Commissioner*, 997 F.2d 1134, 1138-39 (5th Cir. 1993). Furthermore, we wish to avoid the situation in the Third Circuit – divergent treatment for notice and comment regulations depending on whether they are tax or nontax rules. *See Elizabeth Blackwell Ctr. for Women v. Knoll*, 61 F.3d 170, 182 (3d Cir. 1995) (applying *Chevron* to a nontax interpretive regulation), *cert. denied*, 516 U.S. 1093 (1996). We see no reason that nontax regulations issued with notice and comment should receive *Chevron* deference while tax regulations promulgated with the same procedures receive something different.

More importantly, in contrast to our foregoing analysis of the similarities between the traditional rule and *Chevron*, there are some important differences. These considerations also argue in favor of *Chevron*. *Chevron* is the focus of ongoing development by the Supreme Court, especially regarding the scope of the initial inquiry into statutory meaning. *See, e.g., National R.R. Passenger Corp. v. Boston & Marine Corp.*, 503 U.S. 407, 417-18 (1992) (reformulating the first step of *Chevron* analysis by focusing on the plain language of the statute rather than the

intent of Congress). We do not labor under the illusion that *Chevron* will provide monolithic certainty for all courts reviewing administrative rules – we recognize the Court's own inconsistency regarding *Chevron*. *See* Thomas W. Merrill, *Judicial Deference to Executive Precedent*, 101 Yale L.J. 969 (1992) (explaining that "the *Chevron* framework is used in only about half the cases that the Court perceives as presenting a deference question"); *see also* Thomas W. Merrill, *Textualism and the Future of the Chevron Doctrine*, 72 Wash. U. L.Q. 351 (1994). We do hope, however, that by employing a uniform framework for challenges to administrative regulations we can better stay abreast of the Court's dictates.

We also favor *Chevron* because many courts contend that the traditional rule accords less than *Chevron* deference to tax regulations. The Sixth Circuit, for instance, characterizes *National Muffler* as allowing "plenary review" contrasted with *Chevron* deference. *See Peoples Federal*, 948 F.2d at 305. The Third and Fifth Circuits believe that the traditional rule entitles a regulation to "less deference" than under *Chevron*. *See E.I. du Pont*, 41 F.3d at 135 n.23; *Nalle*, 997 F.2d at 1139. As *Atchison* explains, we owe full *Chevron* deference to a regulation issued with the full deliberative procedures. Although we acknowledge the gulf between the idealized *Chevron* and the realized one, we do believe that the structure of *Chevron* encourages a court to defer rather than to interpret. We, therefore, prefer it.

Under *Chevron* deference we apply a two-step analysis: (1) We examine the text of the statute – in this case, the relevant section of the tax code. If the plain meaning of the text either supports or opposes the regulation, then

we stop our analysis and either strike or validate the regulation. But if we conclude the statute is either ambiguous or silent on the issue, we continue to the second step: (2) We examine the reasonableness of the regulation. If the regulation is a reasonable reading of the statute, we give deference to the agency's interpretation. *See National R.R. Passenger Corp.*, 503 U.S. at 417-18; *Chevron*, 467 U.S. 842-43.

While this circuit has examined legislative history during the first step of *Chevron*, *see Illinois EPA v. United States EPA*, 947 F.2d 283, 289 (7th Cir. 1991) ("To ascertain the intent of the law, we must examine the plain meaning of the statute at issue, the language and design of the statute as a whole, and, where necessary, less satisfactory indicia of congressional intent such as legislative history." (citations omitted)), we now seem to lean toward reserving consideration of legislative history and other appropriate factors until the second *Chevron* step, *cf. Alex v. City of Chicago*, 29 F.3d 1235, 1239 (7th Cir. 1994) ("when statutory meaning is clear with respect to the issue at bar judicial inquiry normally should end without heed to the embellishments of secondary materials like legislative history"). In the second step, the court determines whether the regulation harmonizes with the language, origins, and purpose of the statute. While not dispositive, a court may find various considerations informative – these considerations might include the consistency of the agency's interpretation, the contemporaneousness of the interpretation, and the robustness of the regulation following congressional re-enactment of the underlying statute. Although we sometimes describe *Chevron* as a "rubber stamp," *see Atchison*, 44 F.3d at 442, we know that

agencies occasionally act unreasonably. Given the scope of the permissible inquiry under *Chevron*'s second step, we believe that courts can rein in the excesses of unreasonable administrative rulemaking. With that said, however, we reiterate *Chevron*'s fundamental dictate that a court must not "substitute its own construction of a statutory provision for a reasonable interpretation" by the agency in question. 467 U.S. at 844.

At long last, then, we begin our examination of Bankers Life's challenge to Treasury Regulation § 1.815-2(b)(3) under the *Chevron* framework starting with the tax code. Bankers Life seeks to show that the plain meaning of the tax code required the IRS to value distributions according to aggregate adjusted basis. Next, it argues that the regulation unreasonably departed from the harmony and order of the statutory scheme.

Bankers Life, of course, starts by parsing the language of the code section that created the Phase III tax system – I.R.C. § 815:

> For purposes of this section and section 802(b)(3), any *distribution* to shareholders after December 31, 1958, shall be treated as made –
>
> (1) first *out of* the shareholders surplus account, to the extent thereof,
>
> (2) then *out of* the policyholders surplus account, to the extent thereof, and
>
> (3) finally *out of* other accounts.

I.R.C. § 815(a) (emphasis added). The insurance company focuses on the meaning of the terms "distribution" and "out of." Their argument is that "an element cannot be distributed out of an account unless the element had been

included in the account." Specifically, that SSA and PSA never included the portion of the fair market value of the 1983 distribution attributable to unrealized appreciation. Thus, the IRS should not have deducted the appreciation "out of" the SSA or the PSA because the rules never placed the appreciation into those accounts.

Or, phrased another way, the IRS could not have distributed the fair market value out of the SSA and PSA because "distribution involves the concept of being dispensed from a 'whole' that only includes 'parts' within that 'whole,' and a distribution, therefore, cannot include elements that are not a part of the source of the distribution." Even more basically, if we never put the appreciation in the boxes marked SSA and PSA, how could we have taken the appreciation out of those boxes?

Bankers Life also focuses on the statute's use of the word "accounts." Since § 815 referred explicitly to "accounts," logic dictates that it must have mandated some standard form of accounting. The tax code generally employs uniform methods of debit/credit accounting. *See, e.g.*, I.R.C. § 312(a)(3) and Treas. Reg. § 13121(a)-(c) (employing credits/debits system and adjusted basis to measure distributions out of a corporate earnings and profits account during partial liquidation). Since the SSA included only Phase I and II income – after-tax gains – it could not have included unrealized appreciation of assets. Thus, the statute could not have directed the withdrawal of unrealized appreciation from the SSA unless it also allowed for the simultaneous credit of the after-tax gain from that appreciation to the account.

These several arguments lead Bankers Life to the conclusion that Treasury Regulation § 1.815-2(b)(3) defied the statute. It defied the plain meaning of "distribution" and "out of." It defied fundamental principles of accounting evoked by the word "account." Therefore, according to Bankers Life, we should apply the first step of *Chevron* and strike the regulation.

Moving beyond the language of the statute, Bankers Life argues that the regulation constituted an unreasonable interpretation of the code. Bankers Life backs up statutory language argument about "accounts" with reference to the "regular" – as opposed to "phased" – taxation rules. The company explains that, normally, unrealized appreciation inherent in an asset does not become part of taxable income until the owner causes a taxable event by selling or exchanging the asset. As Bankers Life explains, the tax laws mark value with reference to basis, they do not "mark to market." *See Cottage Sav. Ass'n v. Commissioner*, 499 U.S. 554, 559 (1991); *see also Young v. Commissioner*, 923 F.2d 719, 721 (9th Cir. 1991) (stating that principles of taxation do not recognize unrealized gain or loss). Since, in this case, the tax laws did not recognize a taxable event under Phase I or II taxation, Bankers Life contends that § 815 could not have suddenly marked to market and created a taxable event for purposes of Phase III taxation alone.

The core of this argument is that by creating a taxable event under Phase III rules the IRS impermissibly imposed a debit without the corresponding credit. Under the regular tax rules a taxable event imposes a tax burden but also confers an accounting credit by adding after-tax income to the SSA and/or the PSA. A distribution would

then result in a debit – but only after Bankers Life received the benefit of the accounting credit. By computing the value of the 1983 distribution according to market value, the IRS subjected Bankers Life to a debit without ever having given it the corresponding credit. By creating a taxable event solely under Phase III the IRS imposed the detriment of a taxable event without the benefit. Returning to credit/debit accounting principles, since the SSA received no credit for the unrealized appreciation, the IRS could not attempt to extract the unrealized appreciation from the SSA.

To support its interpretation of § 815, Bankers Life points to language in the Senate Finance Committee report. The report described the SSA as containing "amounts on which the tax has already been paid." S. Rep., *supra*, at 26. Since Bankers Life did not yet pay tax on the appreciation element of the real property assets, the SSA could not contain that element and the IRS could not deduct the appreciation from the SSA.

Similarly, the report referred to the PSA as a "cushion." Since the statute did not allow Bankers Life to add the appreciation element to the PSA, it never became part of the "cushion." Thus, § 815 could not have conceived of Bankers Life relying upon the appreciation as part of its special reserve. If the appreciation constituted a portion of the Phase III income protected by special treatment, then the law should have attributed that element to the PSA.

Next, the company focuses on the issue of consistency throughout the tax code. The insurer points to a number of areas in which the tax laws treated the value of

a distribution as the value of the adjusted basis rather than the fair market value. *See, e.g., Fulman v. United States*, 434 U.S. 528 (1978) (explaining that personal holding company dividends are charged to distributing company at fair market value); *H.H. Robertson v. Commissioner*, 59 T.C. 53 (1972) (explaining that debits to foreign subsidiary's earnings and profits account were valued by adjusted basis), *aff'd*, 500 F.2d 399 (3d Cir. 1974). The regulation destroyed an otherwise harmonious measurement of distributions by adjusted basis.

The company also explains the anomaly produced by the difference between the treatment of cash, compared to noncash, distributions. Because of the *General Utilities* doctrine, noncash distributions resulted in no taxable event at the corporate level. The regulation constituted a brazenly impermissible end run around *General Utilities* – an attempt by the IRS to create a Phase III taxable event when no other rule would have imposed a tax.

These arguments lead Bankers Life to the conclusion that, even if Treasury Regulation § 1.815-2(b)(3) did not defy the plain meaning of the statute, it was fundamentally unreasonable given the overall structure of the code. It effectively created a taxable event without any support from the tax law. And it defied the meaning of the statute as revealed in legislative history.

The government responds with several arguments. First, the government points, of course, to the plain language of § 815. It notes that the statute stated that "any distribution shall be *treated* as made" from out of the SSA and PSA. I.R.C. § 815(a) (emphasis added). The use of "treated as" overcomes any attempt to ascribe precise

meaning to "distribute" and "out of" because "treated as" presumed that someone must determine the proper treatment of the distribution. The "treated as" language suggested some level of abstraction, rather than the withdrawal of a concrete asset deposited in a real account. The government expands on this concept by noting that the SSA and PSA were but memorandum accounts, not real asset holding accounts. They constituted bookkeeping entries for the computation of tax, not bank accounts.

This line of argument leads the government to the conclusion that nothing in the controlling statute explained how the IRS should value the distribution. Under *Chevron* analysis, the government explains that the statute was silent on the issue of valuation – the statute contained a gap on this topic and the IRS filled that gap by issuing Treasury Regulation § 1.815-2(b)(3).

The government also argues that "out of" did not conclusively address the question of how to value distribution. *See Fulman*, 434 U.S. at 534 ("out of . . . earnings and profits" language in I.R.C. § 316 did not answer question of how "distribution" is valued). The government claims that "out of" created ambiguity. Thus, again, the government argues that the statute left this question for development by the IRS through regulation.

According to the government, therefore, Treasury Regulation § 1.815-2(b)(3) did not defy the statute. The government argues that the plain language of the statute was either silent or ambiguous on the valuation of noncash distributions. Consequently, we must reach the second step of *Chevron* analysis and decide whether the

regulation constituted a reasonable interpretation of the statute.

To debunk Bankers Life's arguments about inconsistencies, disparities, and anomalies, the government explains that we cannot compare phased taxation to regular taxation. The government finds numerous references in the Senate and House reports to the special tax treatment afforded to life insurance companies under the three-phase structure. Thus, because of the uniqueness of the three-phase structure, the government argues that there is simply no reason for conventional tax accounting principles to apply to the calculation of Phase III taxes. Congress created a unique tax structure and arguments by analogy to conventional taxation shed no light on the reasonableness of Phase III taxation.

The government also advances an argument based on the regulation's longevity and its survival in the face of congressional re-enactment of the underlying statute. This congressional acquiescence argument contends that when a long-standing regulation survives substantial changes to the underlying tax code, we should deem the regulation to have tacit congressional approval and, therefore, the effect of law. *See Cottage Sav. Ass'n*, 499 U.S. at 561. At oral argument, the government attempted to demonstrate congressional awareness of the regulation in legislative history of the Tax Reform Act of 1969. The government bolstered the re-enactment argument by explaining that the IRS promulgated the regulation contemporaneously with the enactment of the three-phase tax structure. *See Atchison*, 44 F.3d at 442 (listing contemporaneousness among the factors supporting a regulation).

Next, the government examines the legislative history of the statute to elucidate congressional intent and shed light on the law's meaning. Both the House and Senate reports on the statute explained that Phase III taxes applied when the life insurance company made distributions to shareholders: "underwriting gains made available to shareholders will be subject to the full payment of tax." S. Rep., *supra*, at 13; H.R. Rep., *supra*, at 9. Because Bankers Life could have sold the real estate assets and realized gains, the IRS argues it properly deducted this value from the SSA and PSA. In effect, the potential income attributable to the appreciation element constituted a reserve held by the company. The government finds support for this line of reasoning in the reports' description of how Phase III taxation should treat distributions of dividends: "where a life insurance company has distributed dividends to stockholders which are in excess of previously taxed income, it becomes clear that the company itself has made a determination that additional amounts constitute income which was not required to be retained to fulfill the policyholders' contracts." S. Rep., *supra*, at 25; H.R. Rep., *supra*, at 15. The government explains that when Bankers Life transferred assets worth over $875 million to the foundation it clearly signaled that it no longer needed an untaxed cushion of $154 million (the amount in the PSA).

In other words, the concept of a cushion, or reserve, embodied the idea of true value. A life insurance company would not let money in a reserve sit idly in a safety deposit box. On the contrary, the company would invest the money in hope of realizing a gain. Taking this argument to its logical conclusion, the government contends

that, by conceiving of Phase III as a deferment mechanism that created a special reserve fund, Congress evinced an intent that Phase III taxation value distributions according to fair market value. Thus, congressional intent embodied in the statute supported the regulation.

Finally, in response to Bankers Life's arguments, the government explains that the regulation did not create taxable income. The entire logic of Phase III taxation involved not the creation of taxable income, but instead the release of taxable income from its special deferred status. The taxable income came into being when the life insurance company made gains from underwriting – the tax code allowed the company to postpone the payment of taxes on half of this income. The deduction of distributions from the memorandum accounts and the valuation of those distributions constituted the methods used to determine when to levy the tax on the Phase III income. In other words, the regulation amounted to no more than a mechanism to determine when and to what extent the IRS should subject Phase III income to its normal tax.

When these arguments were tested in the district court, Judge Plunkett concluded that Bankers Life failed to meet its burden of showing the regulation to be invalid. He reasoned that memo accounts did not necessarily follow the same rules as real accounts. The judge also concluded that, given the unique purpose of special taxation, the regulation was not irrational.

We agree with the district court. Beginning with the statutory language, we cannot glean enough from the plain meaning to determine whether the statute supports or condemns the regulation. The "treated as" language

injects so much ambiguity into the meaning of the statute that we cannot accept Bankers Life's interpretation of "distribution" and "out of" as controlling. The "treated as" language makes it impossible to construe the "accounts" as containing specific funds derived from specific sources.

Even more fundamentally, the plain language of the statute simply fails to address the question of valuation. In other words, the statute is silent on this question. In *Fulman*, the Supreme Court faced a similar situation in which "while obviously some rule of valuation must be applied, Congress . . . failed expressly to provide one." 434 U.S. at 533. Here, too, Congress failed to expressly provide a method of valuation. Because the statute is silent, we should not attempt to infer a method of valuation under the guise of determining the plain meaning of the provision.

Moving to the second step of *Chevron*, Bankers Life fares only a little better. Again, *Fulman* provides us with guidance. The *Fulman* Court recognized the "logical force" of the argument against the regulation in question. *See id.* at 534. Logical force, however, did not carry the day. The Court explained that "but for the Regulation, the argument might well prevail." *Id.* at 536. The Court continued: "[A]s we have indicated, the issue before us is *not* how *we* might resolve the statutory ambiguity in the first instance, but whether there is any reasonable basis for the resolution embodied in the Commissioner's Regulation." *Id.* Similarly, Bankers Life's interpretation does not lack logical force, but neither does it rob the regulation of its reasonableness.

The arguments over congressional intent as revealed in the legislative history are in equipoise. The two sides offer conflicting plausible interpretations of Congress's purpose. And Bankers Life certainly demonstrates that the regulation conflicts with the methods of conventional taxation. But conflicts do not equal irrationality. The IRS may adopt regulations that produce unusual results, so long as those results have some colorable support. As *Chevron* itself explained, an agency may choose among conflicting policies. *See* 467 U.S. at 845. Furthermore, as the government argues, because of the singularity of the Phase III system, any conflicts with regular taxation do not mean very much.

The government also carries the day on the question of whether the regulation creates a taxable event. The regulation merely provides the timing mechanism for the release of Phase III income to taxation – the taxable event occurred when the life insurer earned the Phase III income. Thus, Bankers Life contentions about impermissible marking to market also fail. The IRS did not mark to market to measure the amount of Phase III income earned, it used market value to measure the amount of Phase III income released from its special deferred status.

While we find the government's longevity and reenactment arguments informative, we choose not to place too much weight on them or on the government's argument for the regulation's validity based on its contemporaneity with the passage of the statute. *See Smiley v. Citibank (South Dakota), N.A.*, 116 S. Ct. 1730, 1733 (1996) ("neither antiquity nor contemporaneity with the statute is a condition of validity"). Arguments based on congressional silence presume much. *See Brown v. Gardner*, 513

U.S. 115, 120 (1994) (explaining that arguments based on congressional silence and re-enactment lack persuasive significance). Here, the government's stronger arguments lie elsewhere.

In the end, the government offers a reasonable explanation for the regulation given the origin and purpose of the three-phase taxation scheme. In effect, the IRS adopted a policy that attempted to limit the length of time the insurance company could defer Phase III taxes. Nothing in the three-phase scheme suggested that the IRS could not constrain the benefit of deferment as narrowly as possible. On the contrary, the scheme evinces an intent to tax Phase III income upon large distributions to shareholders. Treasury Regulation § 1.815-2(b)(3) did no more than measure distributions of appreciated real property in the largest manner possible. Because this is not unreasonable given the purpose of the statute, we must AFFIRM.

A true Copy:

Teste:

_____

Clerk of the United States Court of Appeals for the Seventh Circuit

United States Court of Appeals
For the Seventh Circuit
Chicago, Illinois 60604

JUDGMENT – WITH ORAL ARGUMENT

Date: April 17, 1998

BEFORE: Honorable WALTER J. CUMMINGS,
Circuit Judge
Honorable MICHAEL S. KANNE,
Circuit Judge
Honorable TERENCE T. EVANS,
Circuit Judge

No. 96-2260

BANKERS LIFE AND CASUALTY COMPANY,
Plaintiff-Appellant

v.

UNITED STATES OF AMERICA,
Defendant-Appellee

Appeal from the United States District Court for the
Northern District of Illinois, Eastern Division
No. 93 C 4739, Paul E. Plunkett, Judge

The judgment of the District Court is AFFIRMED, with costs, in accordance with the decision of this court entered on this date.

(1061-110393)

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

BANKERS LIFE AND CASUALTY COMPANY,	)	
Plaintiff,	)	No. 93 C 4739
	)	Hon. Paul E. Plunkett
v.	)	
UNITED STATES OF AMERICA,	)	
Defendant.	)	

MEMORANDUM OPINION AND ORDER

This tax refund case is before us on the parties' cross-motions for summary judgment. Plaintiff Bankers Life and Casualty Company ("Bankers Life") seeks tax refunds for the years 1980, 1983, and 1984 on several grounds, which defendant United States of America (the "government") opposes. For the reasons set forth below, we grant the government's motion and deny Bankers Life's motion on all counts.

Discussion

I. Standard

Rule 56(c) of the Federal Rules of Civil Procedure allows us to grant summary judgment "if the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to judgment as a matter of

law." In considering the evidence submitted by the parties, we do not weigh it or determine the truth of asserted matters. *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 249 (1986). We are to view all facts and draw all reasonable inferences in the light most favorable to the non-moving party. *Transamerica Ins. Co. v. South*, 975 F.2d 321, 327 (7th Cir. 1992). Here, the parties have stipulated to the facts necessary to resolve these motions.

Bankers Life has brought each of its three counts, for refunds for tax years 1980, 1983, and 1984, on entirely separate legal grounds. In addition, each presents a different factual scenario. Therefore, we address the facts and the legal issues for each count separately.

II. Settlement of the Golbar Litigation (Count I)

A. Facts

On or about March 10, 1971, Bankers Life and fourteen other lenders (collectively, the "lenders") entered into a stand-by "take-out" commitment (the "commitment") with Golbar Properties, Inc. ("Golbar"), to loan Golbar or its assignee as permanent financing a total of $45,000,000 upon the completion by Golbar of the construction of a forty-four story office building in New York City. (Stip. Facts, ¶ 8.) Bankers Life's portion of the loan commitment was $5,000,000. (*Id.*) Golbar was to use the commitment to obtain from Citibank N.A. a construction loan to finance the construction of the building. (*Id.*) In October 1974, the lenders, including Bankers Life, refused to fund the loan on the grounds that Golbar had failed to perform certain conditions precedent specified in the commitment agreement. (*See id.*, ¶ 9.)

In November 1974, Golbar sued the lenders, including Bankers Life, in the New York state courts over their refusal to fund the loan. (*Id.*, ¶ 10.) Bankers Life, among others, filed a counterclaim. (*Id.*, ¶ 11.) On October 24, 1979 the court entered a money judgment in the amount of $6,495,000 in favor of Citibank N.A. (added as a plaintiff as Golbar's assignee) and against Bankers Life and the other lenders. (*Id.*, ¶¶ 12, 13.) The court also dismissed the counterclaim. (*Id.*, ¶ 14.) On or about June 30, 1980, while the judgment was on appeal, Bankers Life settled the case for $4,545,455, which was just over ninety percent of its original loan commitment. (*Id.*, ¶ 15; Stip. Fact Ex. 5, ¶ 1.) as part of the settlement, Bankers Life received a release from Citibank and the other plaintiffs in the litigation, while it dismissed its counterclaim with prejudice and withdrew its appeal. (*Id.*, ¶ 26; Stip. Fact Ex. 5.)

Bankers Life filed its consolidated corporate federal income tax return (Form 1120L) for tax year 1980 with the Internal Revenue Service ("IRS") on or about September 15, 1981. (*Id.*, ¶ 17.) On its return, it claimed the entire settlement payment in the investment yield category on Schedule A, line 9, as an investment expense item. (*Id.*, ¶ 18.) When the IRS audited Bankers Life's 1980 return, the agent treated the settlement payment as belonging in the gain or loss from operations category on Schedule E, line 19, as an other deductions item. (*Id.*, ¶ 19.) The IRS Appeals Office ultimately agreed to allow $1,326,291 of the settlement payment as an interest expense deduction, but the balance of $3,219,164 was reclassified as an "other deduction" under section 809(d)(1) of the Internal Revenue Code. (*Id.*, ¶ 20.) This resulted in an increase in Bankers Life's federal income tax for tax year 1980, which

was assessed on November 28, 1988. (*Id.*) Bankers Life paid the additional assessed tax on or before December 5, 1988. (*Id.*, ¶ 21.)

On May 26, 1989, Bankers Life filed two refund claims, amending its 1980 tax return, for refund of the additional assessed tax. (*Id.*, ¶ 22.) In one of the refund claims, Bankers Life sought claimed the $3,219,164 as a capital loss. (*Id.*) In January 1993, the IRS disallowed the entire refund claim. (*Id.*, ¶ 23.)

Bankers Life, never discouraged, tried again to get a favorable tax treatment of the Golbar settlement expense. It filed a claim for refund of federal income tax for tax year 1983 (the "1983 refund claim") on about December 30, 1991. (*Id.*, ¶ 28.) In the 1983 refund claim, it included an amended 1983 tax return which reflected, among other changes, a claim for refund of the $3,219,164 paid in settlement of the Golbar litigation as a capital loss carryforward for the 1983 tax year. (*Id.*, ¶ 29.) On or before January 29, 1993, the IRS disallowed the 1983 refund claim. (*Id.*, ¶ 31.)

At issue then in Count I is the proper tax treatment of $3,219,164 paid in settlement of the Golbar litigation. If that amount is treated as a capital loss carryforward, then Bankers Life overpaid its 1983 federal income tax. The parties have not agreed on the amount of the refund if Bankers Life is successful on this claim, but Bankers Life asserts that it would be approximately $900,000 to $1,600,000.

B. Analysis

Bankers Life asserts that the $3,219,164 should be treated as a capital loss carryforward for two reasons. First, it argues that its interest in the Golbar contract was an interest in an executory contract which should properly be treated for tax purposes as a capital asset. It reasons that the mutual releases given as part of the settlement, together with the payment by Bankers Life, constituted the equivalent of a sale or exchange of a capital asset from Bankers Life's standpoint.[1] Alternatively, it contends that then-applicable section 1232 of the Tax Code should apply to the settlement. Section 1232 provided that an amount received on the retirement of an evidence of indebtedness of a corporation was to be treated as an amount received in an exchange. Thus, according to Bankers Life, the settlement transaction gave rise to a capital loss because the "bottom line effect" of settlement was the same as if Bankers Life had made a cash transfer of the loan commitment amount followed by its acceptance of only a partial repayment, accompanied by the parties' mutual releases – a truly ingenious argument.

The government remains unimpressed, arguing that to determine the characterization of the payment, the "origin of the claim" test requires that we examine the pleadings, other court papers, and settlement documents

---

[1] The government points out that Bankers Life never executed a release in favor of the Golbar plaintiffs in connection with the settlement, although it appears undisputed that Bankers Life did forego an appeal.

to determine the nature of the settlement payment. It contends the documents show that the settlement payment did not consist of the sale or exchange of a capital asset at a loss. First, it asserts that Bankers Life cannot be said to have had a capital asset or even property within section 1221 of the Tax Code because it did not have any rights or "bundle of rights" to enforce based upon its breach of the commitment which gave rise to the Golbar litigation. Second, it argues that the release of Bankers Life's obligation did not amount to a sale or exchange because Bankers Life did not receive anything besides the release; rather, the settlement payment was merely the satisfaction of a disputed obligation.

The fundamental issue is whether the loss resulting from the settlement was a capital or an ordinary loss. As the taxpayer seeking a refund, Bankers Life has the burden of proof. *Heublein, Inc. v. United States*, 996 F.2d 1455, 1461 (2d Cir. 1993) (in refund suit, taxpayer has burden of proving overpayment of tax and amount of refund). Bankers Life has not met its burden. Its first premise – that its loan commitment to Golbar was an executory contract that constituted a capital asset – may well be correct, but it has no bearing on the issue here. We recognize that Bankers Life was to receive, pursuant to the commitment, rights to an interest in the building in exchange for loaning the $5,000,000. However, it does not follow from this that any transaction relating to the commitment, regardless of its nature, therefore constitutes a capital gain or loss for tax purposes. Rather, the proper characterization of a particular transaction, such as the one which occurred here, depends upon the facts behind it.

In order for Bankers Life to prevail on this argument, not only must the commitment be properly characterized as a capital asset of Bankers Life, but its settlement of the Golbar litigation must have involved a release of its own rights which constituted a sale or exchange of the capital asset. But, Bankers Life did not settle on the original loan commitment; it settled on the money judgment awarded to Citibank N.A. in the litigation, as the settlement papers make clear. (Stip. Fact Ex. 5.) The money judgment extinguished Bankers Life's rights under the commitment agreement, and it constituted a debt or obligation of Bankers Life, not a capital asset. The cases of *Meisels v. United States*, 732 F.2d 132 (Fed. Cir. 1984), and *Turzillo v. United States*, 346 F.2d 884 (6th Cir. 1965), upon which Bankers Life principally relies, are inapposite, for neither involved settlement on a money judgment. In addition, as the government notes, to be a capital loss, Bankers Life must have sold or exchanged a capital asset resulting in a loss. But, in settling the Golbar litigation, Bankers Life in effect *purchased* a release of its disputed obligations under the commitment; it did not sell anything. If Bankers Life had funded the loan commitment as promised but had not received any interest in the building in return, and had then settled with Citibank N.A., the settlement might have been a capital loss. But that did not happen here.

Bankers Life's second contention, that section 1232 requires that the loss be treated as a capital loss, as equally farfetched. Its "bottom line analysis" posits the tax treatment of a hypothetical transaction, not the one which actually occurred. Bankers Life did not shell out the original $5,000,000 loan as it had committed, and it did not accept only a partial repayment. What it did was

renege on the loan commitment and settle for a portion of that amount only after it had been hit with a money judgment greater than the value of the loan commitment. It has cited us no authority for the proposition that, regardless of the means used (i.e., the taxpayer's actual conduct), the tax treatment of this transaction should be determined solely on the basis of the ends achieved.

The government has established that it properly refused to treat the settlement payment of $3,219,164 as a capital loss. Therefore, we grant the government's motion for summary judgment and deny Bankers Life's motion for summary judgment on Count I.

III. Distributions to the Foundation (Count II)

A. Facts

The Life Insurance Company Income Tax of 1959 established a three phase tax system for life insurance companies, which remained in effect until the statute was repealed in 1983. *See generally* Subchapter L of Internal Revenue Code of 1954 ("I.R.C."). Under this system, "Phase I" taxable income was the lesser of the life insurance company's taxable investment income or its gain from operations, which was roughly the sum of taxable investment income plus underwriting gain. I.R.C. § 802(b)(1). "Phase II" taxable income was one half the amount by which the gain from operations exceeded taxable investment income. I.R.C. § 802(b)(2). Finally, "Phase III" tax was imposed on the remaining one half of the amount by which the gain from operations exceeded taxable investment income; however, tax on this amount was deferred by being credited for tax purposes to a tax

return memorandum account called the "policyholders surplus account" (the "PSA"). I.R.C. § 802(b)(3). This excluded income was subject to taxation upon eventual distribution to the shareholders, at which time the company's Phase III tax obligation arose. *See* I.R.C. § 802(a)(1), 802(b)(3).

A life insurance company was also required to maintain for tax purposes another tax return memorandum account, the "shareholders surplus account" (the "SSA"). I.R.C. § 815(b). The SSA was essentially an accumulated after-tax earnings account, which reflected accumulated after-tax investment income and the accumulated after-tax portion of the one half of underwriting gain that had previously been taxed. *See id.* Distributions during a year to shareholders were first subtracted from the SSA, and then, to the extent of any excess, were subtracted from the PSA. I.R.C. § 815(a). The subtraction from the PSA released into taxable income some or all of the previously untaxed income held in the PSA and triggered the "Phase III" tax. I.R.C. § 802(b)(3).

At the time of the death of John D. MacArthur on January 6, 1978, his Trust No. 1 held all of the capital stock of Bankers Life.[2] (Stip. Facts, ¶¶ 34, 35.) Pursuant to the terms of the trust agreement, that stock was required to be distributed to The John D. and Catherine T. MacArthur Foundation (the "Foundation"). (*Id.* ¶ 35.) This was accomplished on December 1, 1978. (*Id.* ¶ 36.)

---

[2] Bankers Life was a stock life insurance company under Subchapter L of the Internal Revenue Code at all relevant times.

The Foundation, as a private foundation, was subject to limitations relating to its holdings in a business corporation's stock. (*Id.* ¶ 37.) Under then-applicable Section 4943(c)(6) of the Internal Revenue Code, it was required to divest itself of no less than eighty percent of the Bankers Life capital stock within five years, or, in other words, on or before November 30, 1983. (*Id.*) On November 30, 1984, the Foundation obtained an additional five years in which to meet the divestiture requirements. (*Id.* ¶ 43.)

On September 3, 1982, the Bankers Life board adopted a plan of partial liquidation under which, during 1983, Bankers Life would distribute to the Foundation a large number of real estate holdings held by Bankers Life and its non-life insurance company subsidiaries. (*Id.* ¶ 44.) Six days later, the Foundation board ratified Bankers Life's adoption of the plan of partial liquidation. (*Id.* ¶ 45.)

On March 25, 1982, a request for a ruling as to certain federal income tax consequences of the implementation of the plan of partial liquidation was submitted to the IRS. (*Id.* ¶ 47.) The IRS issued its ruling on July 10, 1985, in Letter Ruling 8540070. (*Id.*) In addition, because for state law insurance purposes the plan of partial liquidation involved payment to the Foundation by Bankers Life of an "extraordinary dividend" as defined in the Illinois Insurance Code, by letter of November 23, 1983, Bankers Life sought authorization for such extraordinary dividend from the Illinois Department of Insurance (the "Department"). (*Id.* ¶ 48.) The Department approved the extraordinary dividend on December 30, 1983. (*Id.* ¶ 49.)

Bankers Life made the non-cash distributions of real estate and real estate-related assets to the Foundation pursuant to the plan of partial liquidation during calendar year 1983. (*Id.* ¶ 50.) It filed its consolidated corporate federal income tax return (Form 1120L) for tax year 1983 with the IRS on or before September 17, 1984. (*Id.* ¶ 51.) Pursuant to that return, it paid federal income tax in the amount of $95,923,210. (*Id.* ¶ 52.)

With respect to its 1983 taxable year, Bankers Life had an SSA of $241,014,695 and a PSA of $154,434,319. (*Id.*, ¶¶ 59, 60.) In its 1983 return, in accordance with section 1.815-2(b)(3) of the Treasury Regulations, it reported the distributions to the Foundation on the basis of the fair market value of the assets distributed, which was in excess of $875,000,000, in computing the subtractions from its SSA and PSA. (*Id.*, ¶¶ 56, 62.) Because the fair market value of the assets distributed exceeded the amount in its SSA, the excess was subtracted from its PSA. (*Id.*, ¶ 65.) As a consequence, Bankers Life had to report additional taxable income for 1983 in the amount of $154,434,319, which resulted in a Phase III tax of $71,039,787. (*Id.*, ¶ 57.) Bankers Life paid this tax with its 1983 return. (*Id.*, ¶ 58.)

Bankers Life filed a claim for refund for tax year 1983 in the amount of $72,324,865, plus interest (the "1983 refund claim"), on or before December 30, 1991. (*Id.*, ¶¶ 28, 68.) Of the total refund sought, $70,750,058 represented the Phase III tax it had paid as a result of the 1983 distribution of the non-cash assets, less subsequent adjustments, plus interest. (*Id.*, ¶ 69.) In the 1983 refund claim, Bankers Life contended that section 1.815.2(b)(3) of the Treasury Regulations was invalid and that the non-

cash distributions to the Foundation should have been measured by their adjusted tax basis for purposes of determining the amounts to be subtracted from its SSA and PSA. (*Id.*, ¶ 70.) The adjusted tax basis of the non-cash distributions was $209,650,747. (*Id.*, ¶ 61.) If the non-cash distributions had been measured by their adjusted tax basis, then Bankers Life would have owed no Phase III tax in 1983. (*Id.*, ¶¶ 64, 70.) The IRS disallowed the full amount of the 1983 refund claim on or before January 29, 1993. (*Id.*, ¶ 71.)

B. Analysis

Bankers Life contends that it is entitled a refund in the amount of $70,750,058 in Phase III income tax it paid for the taxable year ending December 31, 1983, on the ground that Treasury Regulation § 1.815-2(b)(3) is invalid. It argues that the regulation improperly requires that, in charging distributions to shareholders against its SSA and PSA, the amount to be charged is based on the fair market value, rather than on the adjusted after tax basis, of the property distributed. According to Bankers Life, use of the fair market value improperly included unrealized appreciation.

Before we examine the regulation in question, we consider our standard of review. Generally, Treasury regulations are entitled to great deference and must be sustained unless unreasonable and plainly inconsistent with the revenue statutes. *Commissioner v. Portland Cement Company of Utah*, 450 U.S. 156, 169 (1981), They must be upheld as long as they are found to "implement the congressional mandate in some reasonable manner."

United States v. Cartwright, 411 U.S. 546, 660 (1973). The precise standard applicable to a given regulation is determined by the source of the authority for the regulation, which is one of two things. The source may be section 7805(a) of the Tax Code, which allows the Commissioner of the Internal Revenue Service to "prescribe all needful rules and regulations for the enforcement of this title," I.R.C. § 7805(a), or else it may be specific statutory grant of authority. *Gehl Co. v. Commissioner*, 795 F.2d 1324, 1328 (7th Cir. 1986). The former is called an "interpretative" regulation, and it is entitled to deference as a reasonable interpretation of the congressional mandate to the extent that "it harmonizes with the statute's language, origin, and purpose." *Id.* at 1329. A regulation is harmonious with a statute's language even if "the statutory language will support a contrary interpretation." *Id.* (quoting *United States v. Vogel Fertilizer. Co.*, 455 U.S. 16, 26 (1982)). The latter type of regulation is a "legislative" regulation, and it is entitled to greater deference than an interpretative one. *Id.* at 1238.

The parties do not dispute that the regulation at issue, section 1.815-2(b)(3), is interpretative. The regulation states, in pertinent part,

> Except in the case of a distribution in cash and as otherwise provided herein, the amount to be charged to the special surplus accounts referred to in subparagraph (1) of this paragraph [the SSA and the PSA] with respect to any distributions to shareholders (as defined in Section 815(a) and paragraph (c) of this section) shall be the fair market value of the property distributed, determined as of the date of distribution.

Treas. Reg. § 1.815-2(b)(3). Bankers Life contends that it is invalid because it is inconsistent with the underlying statutory provisions of the Code and the underlying statutory scheme, which, it argues, require that the amount to be charged be measured on its adjusted tax basis.

Bankers Life raises five arguments in support of its position. First, it contends that the underlying Internal Revenue Code provisions, section 815(a)(1) and section 815(b)(3)(A), provide that a distribution must be "out of" the SSA in order to be a reduction from the SSA. However, the unrealized appreciation element in the assets distributed in 1983 was not reflected in the SSA immediately prior to the distribution, and the distribution was not a taxable event which would have required that the unrealized appreciation be added to the SSA. Therefore, according to Bankers Life, the unrealized appreciation was not a distribution "out of" the SSA.

Second, Bankers Life asserts that, under basic tax accounting principles, credits and debits to a tax account must be based on the same measure. Under the statutory rules, amounts credited to the SSA are measured on an adjusted tax basis, so that, absent evidence that Congress intended otherwise, amounts debited from the SSA must be measured on the same basis. But, the regulation improperly measures the amount to be debited from the SSA by its fair market value instead.

Third, Bankers Life argues that the Internal Revenue Code requires that distributions be charged last to the PSA (and first to the SSA). In this case, even after the

distribution at issue, Bankers Life still held assets corresponding to the amount in its PSA, so that no part of the PSA can be deemed to have been distributed.

Fourth, Bankers Life asserts that it was Congress' intent that the Life Insurance Company Income Tax Act of 1959 would not affect the general rules of taxation except as specifically mandated by the statute. However, according to Bankers Life, the fair market value rule of section 1.815-2(b)(3) results in a substantial taxable gain which would otherwise not have resulted from the distribution under the then applicable tax laws.

Lastly, Bankers Life contends that the fair market value rule is inconsistent with the rules applicable to other tax areas in 1983 relating to the treatment of property distributions from the standpoint of the distributing corporation, which required that the property distributions be measured by adjusted tax basis. But, it argues, there is no evidence that Congress intended that the rule under section 815 of the Internal Revenue Code to be different from the prevailing rule in other areas of the Code.

The government defends Treas. Reg. § 1.815-2(b)(3) on several grounds, of which we address only a few. First, it contends that the regulation is valid as a reasonable interpretation of the statute because the fair market value rule is consistent with the "amount" language of section 815 (which section, the government notes, says nothing about adjusted tax basis). Moreover, section 815 requires that a distribution to shareholders "shall be treated as" out of the SSA first and the PSA last, not that the distribution actually comes from assets held in those

accounts, which do not hold assets at all. Furthermore, it argues, the regulation is consistent with the purpose behind the three phase income tax for life insurance companies, as set forth in the legislative history. According to the government, under the Life Insurance Company Income Tax Act of 1959, Congress viewed the tax deferral mechanism of Phases II and III as justified by the difficulty, due to the long-term nature of life insurance contracts, in ascertaining the underwriting income of a life insurance company on an annual basis. Accordingly, Congress provided that the income tax be deferred on half of what was apparently underwriting income in any particular year. This tax deferral provided a cushion for the long-term contingencies allegedly inherent in the life insurance business. Consequently,

> whe[n] a life insurance company . . . distribute[s] dividends to stockholders which are in excess of the previously taxed income, it becomes clear that the company itself has made a determination that the additional amounts constitute income which [is] not required to be retained to fulfill the policyholders' contracts.

See 1959 Act S. Rep. No. 291, 86th Cong., 1st Sess. at 13, *reprinted in* 1959-2 C.B. 770, 788.

Additionally, the government argues that Bankers Life's contentions are based upon a fundamental mischaracterization of the nature of the SSA and the PSA. Those accounts, its [sic] argues, do not hold any assets; they are merely tax return memoranda accounts which record, in the instance of the SSA, the amount of income on which tax has already been paid and, in the instance of the PSA, the amount of income upon which tax has been

deferred. *See* 1959 Act S. Rep. No. 291, 86th Cong., 1st Sess. at 13, *reprinted in* 1959-2 C.B. 770, 788-89. Thus, there is nothing unreasonable about Treas. Reg. § 1.815-2(b)(3), which measures the amount charged to the SSA and the PSA by the fair market value of the assets distributed. And, according to the government, it is immaterial that the unrealized appreciation on the distributed assets was never "in" the SSA, because Bankers Life was not taxed on the unrealized appreciation, only on the amount charged against its PSA. On the same basis, the government argues that there is no merit to Bankers Life's contention that amounts "credited" to the SSA are held on an adjusted tax basis, because the SSA does not hold assets at all.

The government responds to Bankers life's third contention by noting that it is nothing more than another possible interpretation of the regulation. But, the government points out, the choice among reasonable interpretations of the regulations lies with the Secretary of the Treasury, not with Bankers Life or this Court.[3] Hence, unless Bankers Life shows that the Secretary's interpretation is unreasonable, we must defer to it.

We do not address the government's responses to Bankers Life's fourth and fifth contentions because we need not reach them to resolve the issue before us. We agree with the government that, however meritorious or reasonable Bankers Life's contentions may be, Bankers Life has failed to meet its burden of showing that section

---

[3] The government does not concede that Bankers Life's interpretation is reasonable. (Def.'s Br. at 33.)

1.815-2(b)(3) is invalid.[4] Many of Bankers Life's contention are founded upon a mischaracterization of the SSA and the PSA as asset holding accounts rather than tax return memoranda accounts. As a consequence, these contentions do not establish either that the regulation at issue is unreasonable and plainly inconsistent with the revenue statutes or that it is not a reasonable interpretation of the congressional mandate in harmony with the statute's language, origin, and purpose. Rather, the government has adequately demonstrated that, given the unique treatment of income tax issues for life insurance companies under the Life Insurance Company Income Tax Act of 1959, the fair market rule in section 1.815-2(b)(3) is reasonable and harmonizes with the language, origin and purpose of section 815. Therefore, we grant the government's motion for summary judgment and deny Bankers Life's motion for summary judgment on Count II.

IV. The Section 338 Election (Count III)

A. Facts

As of January 1, 1984, the Foundation continued to own all of the capital stock of Bankers Life. (Stip. Facts, ¶ 73.) At that time, Bankers Life's assets consisted primarily of assets used in its insurance operations and

---

[4] We note for the record that we have not considered the "expert" report of Bruce W. Foudree, submitted by the government, because we consider it both unnecessary to our understanding of the legal issues and inappropriate for consideration on these motions, which we are deciding as a matter of law.

certain real estate interests which had not been distributed pursuant to the plan of partial liquidation. (*Id.*, ¶ 74.)

On May 10, 1984, the Foundation executed a stock purchase agreement with ICH Corporation ("ICH"), pursuant to which the Foundation sold all of the capital stock of Bankers Life to ICH. (*Id.*, ¶ 75.) The sale closed on October 30, 1984. (*Id.*, ¶ 79.)

On July 11, 1986, ICH filed with the IRS an election under section 338(g) of the Internal Revenue Code. (*Id.*, ¶ 80.) ICH listed Bankers Life and each of Bankers Life's life insurance company subsidiaries as includable target corporations in this election. (*Id.*, ¶ 80.) As a result of the election, the taxable year of Bankers Life and its subsidiaries ended as of October 30, 1984. (*Id.*, ¶ 81.)

On or before September 16, 1985, Bankers Life filed its consolidated corporate federal income tax return (Form 1120L) for the short tax period ending October 30, 1984. (*Id.*, ¶ 82.) At the same time, Bankers Life paid federal income tax in the amount of $20,119,900 pursuant to that return. (*Id.*, ¶ 83.) It filed its consolidated corporate federal income tax return for its seven life insurance company subsidiaries. (*Id.*, ¶ 84.) As a result of the section 338 election by ICH, Bankers Life reported on its 1984 short period tax return additional taxable income pursuant to section 815(a)(2) of the Internal Revenue Code in the amount of $38,705,072, resulting in a federal income tax of $17,804,319. (*Id.*, ¶ 86.) Bankers Life paid that tax when it filed its return. (*Id.*, ¶ 87.)

On or before December 30, 1991, Banker Life filed a Form 1120X claim with the IRS for refund of federal

income tax for the short tax period ended October 30, 1984, in the amount of $17,889,639, representing the 1984 federal income tax it paid which was attributable to the aggregate amount of the PSAs of its life insurance company subsidiaries, as adjusted by the appeals settlement, plus interest (the "1984 refund claim"). (*Id.*, ¶ 88.) On or before January 29, 1993, the IRS disallowed the full amount of the 1984 refund claim. (*Id.*, ¶ 89.)

B. Analysis

Before we reach the issues raised by Bankers Life in support of their refund claim, we consider the applicable statutory scheme. In the Tax Reform Act of 1984, Congress largely did away with the three phase tax scheme for life insurance companies. However, for life insurance companies which retained balances in their PSAs, direct or indirect distributions to shareholders from their PSAs still triggered Phase III tax liability under revised section 815 of the Internal Revenue Code. In other words,

> In general the [1984 Act] eliminates any further deferral with regard to income for 1984 and later years. Although companies will not be able to enlarge their policyholder surplus account after 1983, they will not be taxed on previously deferred amounts unless they are treated as distributed to shareholders or subtracted from the policyholders surplus account [PSA] under rules comparable to those provided under the 1959 Act, but which reflect the basic changes in the tax structure under the [1984 Act].
>
> The [1984 Act] provides that any direct or indirect distribution to shareholders from an

> existing policyholders surplus account of a stock life insurance company will be subject to tax at the corporate rate in the taxable year of the distribution. For these purposes, the term distribution is intended to include actual and constructive distributions. *See Union Bankers Ins. Co.*, 64 T.C. 807 (1975).

1984 Act H.R. Rep. No. 423, pt. 2, 98th Cong., 1st Sess., at 141011, *reprinted in* 1984 U.S.C.C.A.N. 697, at 1055. Additionally,

> The statutory emphasis on taxing both direct and indirect distributions from the policyholders' surplus account was intended to be construed broadly, whether or not there is a distribution specifically within the meaning of section 301 or 302. . . . There would be an indirect distribution . . . whenever policyholders' surplus account funds are used to benefit the shareholders indirectly. . . .
>
> When there are distributions from the policyholders' surplus account, the amount of the distribution (whether actual or deemed, or by the indirect use of the amounts in the policyholders' surplus account for the benefit of shareholders), is taxed . . .

Staff of the Joint Committee on Taxation, 98th Cong., 2d Sess., *General Explanation of the Revenue Provisions of the Tax Reform Act of 1984* at 594 (1984).

Section 338(a) of the Internal Revenue Code, as in effect in 1984, states, in pertinent part:

> For purposes of this subtitle, if a purchasing corporation makes an election under this section . . . then, in the case of any qualified stock purchase, the target corporation –
>
> > (1) shall be treated as having sold all of its assets at the close of the acquisition date at fair market value in a single transaction [to which section 337 regarding certain complete liquidations applies,] and
> >
> > (2) shall be treated as a new corporation which purchased all of the assets referred to in paragraph (1) of the beginning of the day after the acquisition date.

I.R.C. § 338(a). Under this provision, a corporation that elects, or is deemed to have elected, under this section shall treat a qualified stock purchase as a purchase of assets that the target corporation sold pursuant to a complete liquidation under section 337. Then, the purchasing corporation obtains a step-up in basis of the assets of the target corporation, because it treats the stock acquisition as an asset acquisition, *see* I.R.C. § 1012, even though no liquidation of the target corporation actually occurs. The target corporation is treated for federal income tax purposes as an unrelated "new" corporation that now holds the assets formerly held by the "old" corporation. I.R.C. § 338(a)(2); Treas. Reg. § 1.338-2(d). In addition, because under section 338(h)(3)(B), the "new" target corporation of a corporation making a section 338 election is deemed to have purchased the stock of any of the "old" target corporation's subsidiaries, that purchase itself may be eligible for a section 338 election, whether actually elected or deemed elected under section 338(e). *See* I.R.C.

§ 339(h)(3)(B). In determining whether a section 338 election results in a distribution for tax purposes, we must look to section 815(f) of the 1959 Act, which is applicable through incorporation by section 815(f) of the 1984 Act. Section 815 defines "distribution" as "any distribution . . . in . . . complete liquidation of the corporation. . . . " I.R.C. § 815(f) (1983).

In this case, ICH made a section 338 election with respect to both Bankers Life and its subsidiaries, and it thus obtained a step-up in basis of both Bankers Life's and the subsidiaries' assets. Consequently, Bankers Life's seven life insurance company subsidiaries were treated as having sold all of their assets in a complete liquidation pursuant to section 338(a)(1). For income tax purposes, then, ICH's section 338 election resulted in an indirect distribution which triggered the Phase III tax.

Bankers Life asserts that ICH's section 338 election should not have been treated as a distribution to shareholders from the SSAs and PSAs of Bankers Life's seven subsidiaries under section 815 so as to trigger Phase III tax on those amounts. It argues that in fact none of the seven subsidiaries made any direct or indirect distribution to their shareholders. Therefore, it argues, it is entitled to a refund of the Phase III tax it paid based on the alleged distributions.

The governments make two responses. First, it asserts that Congress' reference to the *Union Bankers Ins. Co.* case in the House report is instructive. In that case, the Tax Court held, among other things, that the "shall be *treated as* a distribution" language of I.R.C. § 304(a)(2) caused a constructive distribution from Union Bankers to

its controlling shareholder, General Insurance Investment Co. ("General"), when Union Bankers' subsidiary, Bankers Service Life Insurance Co., purchased stock of Union Bankers from General. According to the government, Congress' reference to this case indicates its intent to include constructive distributions under Internal Revenue Code provisions using terms such as "treated as" as distributions within the meaning of section 815 of the 1984 Act. Second, it contends that its interpretation of the "treated as" language is consistent with the legislative intent to "construe broadly" the terms "direct or indirect distributions." Staff of the Joint Committee on Taxation, 98th Cong., 2d Sess., *General Explanation of the Revenue Provisions of the Tax Reform Act of 1984* at 594 (1984). And, in this case, the amounts reflected in the seven subsidiaries' PSAs benefited Bankers Life indirectly because the deemed distributions in liquidation and resulting step-up in bases entitled the subsidiaries to substantial future deductions through amortization of intangible "insurance in force" accounts.

We agree with the government that the section 338 election triggered Phase III tax liability because the election required that the seven subsidiaries be considered as having sold their assets in a complete liquidation, thus triggering the distribution requirement of section 815(f). The essence of Bankers Life's argument is that an actual distribution to shareholders from the seven subsidiaries' PSAs must have occurred before Phase III tax liability could be triggered. We fully recognize that no actual distribution to shareholders of the seven subsidiaries took place. But, as the House report on the 1984 Act

makes clear, distribution means both actual and constructive distributions. 1984 Act H.R. Rep. No. 423, pt. 2, 98th Cong., 1st Sess., at 1410-11, *reprinted in* 1984 U.S.C.C.A.N. 697, at 1055. Here, the distribution was constructive, rather than actual. Thus, Bankers Life's argument that no actual distribution occurred misses the mark.

Bankers Life has failed to show that it is entitled to judgment as a matter of law on its 1984 refund claim, while the government has demonstrated that it is. Therefore, we grant the government's motion for summary judgment and deny Bankers Life's motion for summary judgment on Count III.

Conclusion

For the forgoing reasons, we grant defendant United States of America's motion for summary judgment and deny plaintiff Bankers Life and Casualty Company's motion for summary judgment on all counts. This order is final and appealable.

ENTER:

/s/ Illegible
UNITED STATES
DISTRICT JUDGE

DATED: March 22, 1996

United States District Court

NORTHERN DISTRICT OF ILLINOIS

Eastern Division

JUDGMENT IN A CIVIL CASE

BANKERS LIFE AND CASUALTY COMPANY,

Plaintiff

vs.

UNITED STATES OF AMERICA,

Defendant.

CASE NUMBER: 93 C 4739

_ Jury Verdict. This action came before the Court for a trial by jury. The issues have been tried and the jury has rendered its verdict.

X Decision by Court. This action came to a hearing before the Court. The issues have been heard and a decision has been rendered.

IT IS ORDERED AND ADJUDGED that defendant, United States of America's motion for summary judgment is granted. Plaintiff, Bankers Life and Casualty Company's motion for summary judgment is denied on all counts.

This order is final and appealable.

March 22, 1996
Date

H. Stuart Cunningham
Clerk

/s/ Terry Kinney
(By) Deputy Clerk

§ 802. Tax imposed

(a) Tax imposed. –

(1) In general. – A tax is hereby imposed for each taxable year on the life insurance company taxable income of every life insurance company. Such tax shall consist of a tax computed as provided in section 11 as though the life insurance company taxable income were the taxable income referred to in section 11.

(2) Alternative tax in case of capital gains. – If for any taxable year any life insurance company has a net capital gain, then, in lieu of the tax imposed by paragraph (1), there is hereby imposed a tax (if such tax is less than the tax imposed by such paragraph) which shall consist of the sum of –

(A) a partial tax, computed as provided by paragraph (1), on the life insurance company taxable income determined by reducing the taxable investment income, and the gain from operations, by the amount of such net capital gain, and

(B) an amount determined as provided in section 1201(a) on such net capital gain.

(b) Life insurance company taxable income defined. – For purposes of this part, the term "life insurance company taxable income" means the sum of –

(1) the taxable investment income (as defined in section 804) or, if smaller, the gain from operations (as defined in section 809),

(2) if the gain from operations exceeds the taxable investment income, an amount equal to 50 percent of such excess, plus

(3) the amount subtracted from the policyholders surplus account for the taxable year, as determined under section 815.

(Added Pub.L. 86-69, § 2(a), June 25, 1959, 73 Stat. 115, and amended Pub.L. 87-858, § 3(b)(1), Oct. 23, 1962, 76 Stat. 1136; Pub.L. 88-272, Title II, § 235(c)(1), Feb. 26, 1964, 78 Stat. 126; Pub.L. 91-172, Title V, § 511(c)(1), Dec. 30, 1969, 83 Stat. 637; Pub.L. 94-455, Title XIX, § 1901(a)(95), (b)(33)(E), Oct. 4, 1976, 90 Stat. 1780, 1801; Pub.L. 95-600, Title III, § 301(b)(8), Nov. 6, 1978, 92 Stat. 2821.)

§ 815. Distributions to shareholders

(a) General rule. – For purposes of this section and section 802(b)(3), any distribution to shareholders after December 31, 1958, shall be treated as made –

(1) first out of the shareholders surplus account, to the extent thereof,

(2) then out of the policyholders surplus account, to the extent thereof, and

(3) finally out of other accounts.

(b) Shareholders surplus account. –

(1) In general. – Each stock life insurance company shall, for purposes of this part, establish and maintain a shareholders surplus account. The amount in such account on January 1, 1958, shall be zero.

(2) Additions to account. – The amount added to the shareholders surplus account for any taxable year beginning after December 31, 1957, shall be the amount by which –

(A) the sum of –

(i) the life insurance company taxable income (computed without regard to section 802(b)(3)),

(ii) in the case of a taxable year beginning after December 31, 1958, the amount (if any) of the net capital gain, reduced (in the case of a taxable year beginning after December 31, 1961) by the amount referred to in clause (i),

(iii) the deductions for dividends received provided by sections 243, 244, and

245 (as modified by section 809(d)(8)(B)) and the amount of interest excluded from gross income under section 103, and

(iv) the small business deduction provided by section 809(d), (10), exceeds

(B) the taxes imposed for the taxable year by section 802(a), determined without regard to section 802(b)(3).

(3) Subtractions from account. –

(A) In general. – There shall be subtracted from the shareholders surplus account for any taxable year the amount which is treated under this section as distributed out of such account.

(B) Distributions in 1958. – There shall be subtracted from the shareholders surplus account (to the extent thereof) for any taxable year beginning in 1958 the amount of distributions to shareholders made during 1958.

(c) Policyholders surplus account. –

(1) In general. – Each stock life insurance company shall, for purposes of this part, establish and maintain a policyholders surplus account. The amount in such account on January 1, 1959, shall be zero.

(2) Additions to account. – The amount added to the policyholders surplus account for any taxable year beginning after December 31, 1958, shall be the sum of –

(A) an amount equal to 50 percent of the amount by which the gain from operations exceeds the taxable investment income,

(B) the deduction for certain nonparticipating contracts provided by section 809(d)(5) (as limited by section 809(f)), and

(C) the deduction for accident and health insurance and group life insurance contracts provided by section 809(d)(6) (as limited by section 809(f)).

(3) Subtractions from account. – There shall be subtracted from the policyholders surplus account for any taxable year an amount equal to the sum of –

(A) the amount which (without regard to subparagraph (B)) is treated under this section as distributed out of the policyholders surplus account, and

(B) the amount by which the tax imposed for the taxable year by section 802(a) is increased by reason of section 802(b)(3).

(d) Special rules. –

(1) Election to transfer amounts from policyholders surplus account to shareholders surplus account. –

(A) In general. – A taxpayer may elect for any taxable year for which it is a life insurance company to subtract from its policyholders surplus account any amount in such account as of the close of such taxable year. The amount so subtracted, less the amount of the tax imposed with respect to such amount by reason of section 802(b)(3), shall be added to the shareholders surplus account as of the beginning of the succeeding taxable year.

(B) Manner and effect of election. – The election provided by subparagraph (A) shall be made (in such manner and in such form as the Secretary may by regulations prescribe) after the close of the taxable year and not later than the time prescribed by law for filing the return (including extensions thereof) for the taxable year. Such an election, once made, may not be revoked.

(2) Termination as life insurance company. –

(A) Effect of termination. – Except as provided in section 381(c)(22) (relating to carryovers in certain corporate readjustments), if –

(i) for any taxable year the taxpayer is not an insurance company, or

(ii) for any two successive taxable years the taxpayer is not a life insurance company,

then the amount taken into account under section 802(b)(3) for the last preceding taxable year for which it was a life insurance company shall be increased (after the application of subparagraph (B)) by the amount remaining in its policyholders surplus account at the close of such last preceding taxable year.

(B) Effect of certain distributions. – If for any taxable year the taxpayer is an insurance company but not a life insurance company, then any distribution to shareholders during such taxable year shall be treated as made on the last day of the last

preceding taxable year for which the taxpayer was a life insurance company.

(3) Treatment of certain indebtedness. – If –

(A) the taxpayer makes any payment in discharge of its indebtedness, and

(B) such indebtedness is attributable to a distribution by the taxpayer to its shareholders after February 9, 1959,

then the amount of such payment shall, for purposes of this section and section 802(b)(3), be treated as a distribution in cash to shareholders, but only to the extent that the distribution referred to in subparagraph (B) was treated as made out of accounts other than the shareholders and policyholders surplus accounts.

(4) Limitation on amount in policyholders surplus account. – There shall be treated as a subtraction from the policyholders surplus account for a taxable year for which the taxpayer is a life insurance company the amount by which the policyholders surplus account (computed at the end of the taxable year without regard to this paragraph) exceeds whichever of the following is the greatest –

(A) 15 percent of life insurance reserves at the end of the taxable year,

(B) 25 percent of the amount by which the life insurance reserves at the end of the taxable year exceed the life insurance reserves at the end of 1958, or

(C) 50 percent of the net amount of the premiums and other consideration taken

into account for the taxable year under section 809(c)(1).

The amount so treated as subtracted, less the amount of the tax imposed with respect to such amount by reason of section 802(b)(3), shall be added to the shareholders surplus account as of the beginning of the succeeding taxable year.

(5) Reduction of policyholders surplus account for certain unused deductions. – If –

(A) an amount added to the policyholders surplus account for any taxable year increased (or created) a loss from operations for such year, and

(B) any portion of the increase (or amount created) in the loss from operations referred to in subparagraph (A) did not reduce the life insurance company taxable income for any taxable year to which such loss was carried,

the policyholders surplus account for the taxable year referred to in subparagraph (A) shall be reduced by the amount described in the subparagraph (B).

(6) Restoration of amounts distributed out of policyholders surplus account. – Notwithstanding any other provision of this subchapter, no amount shall be subtracted from a taxpayer's policyholders surplus account with respect to a distribution made during the last month of the taxable year which, without regard to this paragraph, would be treated in whole or in part as a distribution out of the policyholders surplus account, to the extent that amounts so distributed are returned to the taxpayer no later than the time prescribed by law (including

extensions thereof) for filing the taxpayer's return for the taxable year in which the distribution was made. For purposes of this paragraph, amounts returned to a taxpayer with respect to a distribution shall be first applied to the return of amounts which, without regard to this paragraph, would have been treated as distributed out of the policyholders surplus account. This paragraph shall not apply if, at the time such distribution was made, the taxpayer intended to avail itself of the provisions of this paragraph by having its shareholders return all or a part of such distribution. Nothing in this paragraph shall affect the tax treatment of the receipt of the distribution by any shareholder, and the basis to a shareholder of his stock in the taxpayer shall not be increased by reason of amounts returned under this paragraph to the extent that a dividends received deduction or exclusion was allowable in respect of the distribution of such amount under any provision of this title.

(e) Special rule for certain mutualizations. –

(1) In general. – For purposes of this section and section 802(b)(3), any distribution to shareholders after December 31, 1958, in acquisition of stock pursuant to a plan of mutualization shall be treated –

(A) first, as made out of paid-in capital and paid-in surplus, to the extent thereof,

(B) thereafter, as made in two allocable parts –

(i) one part of which is made out of the other accounts referred to in subsection (a)(3), and

(ii) the remainder of which is a distribution to which subsection (a) applies.

(2) Special rules. –

(A) Allocation ratio. – The part referred to in paragraph (1)(B)(i) is the amount which bears the same ratio to the amount to which paragraph (1)(B) applies as –

(i) the excess (determined as of December 31, 1958, and adjusted to the beginning of the year of the distribution as provided in subparagraph (B)) of the assets over the total liabilities, bears to

(ii) the sum (determined as of the beginning of the year of the distribution) of the excess described in clause (i), the amount in the shareholders surplus account, plus the amount in the policyholders surplus account.

(B) Adjustment for certain distributions. – The excess described in subparagraph (A)(i) shall be reduced by the aggregate of the prior distributions which have been treated under subsection (a)(3) as made out of accounts other than the shareholders surplus account and the policyholders surplus account.

(f) Distribution defined. – For purposes of this section, the term "distribution" includes any distribution in redemption of stock or in partial or complete liquidation of the corporation, but does not include –

(1) any distribution made by the corporation in its stock or in rights to acquire its stock;

(2) except for purposes of subsection (a)(3) and subsection (e)(2)(B), any distribution in redemption of stock issued before 1958 which at all times on and after the date of issuance and on and before the date of redemption is limited as to dividends and is callable, at the option of the issuer, at a price not in excess of 105 percent of the sum of the issue price and the amount of any contribution to surplus made by the original purchaser at the time of his purchase; or

(3) any distribution after December 31, 1963, of the stock of a controlled corporation to which section 355 applies, if such controlled corporation is an insurance company subject to the tax imposed by section 831 and if –

(A) control was acquired prior to January 1, 1958, or

(B) control has been acquired after December 31, 1957 –

(i) in a transaction qualifying as a reorganization under section 368(a)(1)(B), if the distributing corporation has at all times since December 31, 1957, owned stock representing not less than 50 percent of the total combined voting power of all classes of stock entitled to vote, and not less than 50 percent of the value of all classes of stock, of the controlled corporation, or

(ii) solely in exchange for stock of the distributing corporation which stock is immediately exchanged by the controlled corporation in a transaction qualifying as a reorganization under

section 368(a)(1)(A) or (C), if the controlled corporation has at all times since its organization been wholly owned by the distributing corporation and the distributing corporation has at all times since December 31, 1957, owned stock representing not less than 50 percent of the total combined voting power of all classes of stock entitled to vote, and not less than 50 percent of the value of all classes of stock, of the corporation the assets of which have been transferred to the controlled corporation in the section 368(a)(1)(A) or (C) reorganization;

(4) any distribution after December 31, 1966, of the stock of a controlled corporation to which section 355 applies, if such distribution is made to a corporation which immediately after the distribution is in control (within the meaning of section 368(c)) of both the distributing corporation and such controlled corporation and if such controlled corporation is a life insurance company of which the distributing corporation has been in control at all times since December 31, 1957; or

(5) any distribution after December 31, 1968, of the stock of a controlled corporation to which section 355 applies, if such distribution is made to a corporation which immediately after the distribution is the owner of all the stock of all classes of both the distributing corporation and such controlled corporation and if, immediately before the distribution, the distributing corporation had been the owner of all of the stock of all classes of such controlled corporation at all times since December 31, 1957.

Paragraphs (3), (4), and (5) shall not apply to that portion of the distribution of stock of the controlled corporation equal to the increase in the aggregate adjusted basis of such stock after December 31, 1957, except to the extent such increase results from an acquisition of stock in the controlled corporation in a transaction described in paragraph (3)(B). If any part of the increase in the aggregate adjusted basis of stock of the controlled corporation after December 31, 1957, results from the transfer (other than as part of a transaction described in paragraph (3)(B)) by the distributing corporation to the controlled corporation of property which has a fair market value in excess of its adjusted basis at the time of the transfer, paragraphs (3), (4), and (5) also shall not apply to that portion of the distribution equal to such excess.

(g) Certain distributions related to former subsidiaries. – If subsection (f)(5) applied to the distribution by a life insurance company of the stock of a corporation which was a controlled corporation –

(1) any distribution by such corporation to its shareholders (after the date of the distribution of its stock by the life insurance company), and

(2) any disposition of the stock of such corporation by the distributee corporation,

shall, for purposes of this section, be treated as a distribution to its shareholders by such life insurance company, until the amounts so treated equal the amount of the distribution of such stock which by reason of subsection (f)(5) was not included as a distribution for purposes of this section.

(Added Pub.L. 86-69, § 2(a), June 25, 1959, 73 Stat. 129, and amended Pub.L. 87-790, § 3(b), Oct. 10, 1962, 76 Stat. 808; Pub.L. 87-858, § 3(b)(4), (e), Oct. 23, 1962, 76 Stat. 1137; Pub.L. 88-571, §§ 2, 3(a), 4(a), Sept. 2, 1964, 78 Stat. 857, 859; Pub.L. 90-225, § 4(a), (b), Dec. 27, 1967, 81 Stat. 733, 734; Pub.L. 91-172, Title IX, § 907(b), Dec. 30, 1969, 83 Stat. 715; Pub.L. 94-331, § 1(a), June 30, 1976, 90 Stat. 781; Pub.L. 94-455, Title XIX, §§ 1901(b)(1)(O), (24), (33)(H), 1906(b)(13)(A), Oct. 4, 1976, 90 Stat. 1791, 1798, 1801, 1834.)

§ 1.815-2 Distributions to shareholders.

(a) In general. Section 815 provides that every stock life insurance company subject to the tax imposed by section 802 shall establish and maintain two special surplus accounts for Federal income tax purposes. These special accounts are the shareholders surplus account (as defined in section 815(b) and § 1.815-3) and the policyholders surplus account (as defined in section 815(c) and § 1.815-4). To the extent that a distribution to shareholders (as defined in paragraph (c) of this section) is treated as being made out of the shareholders surplus account, no tax is imposed on the company with respect to such distribution. However, to the extent that a distribution to shareholders is treated as being made out of the policyholders surplus account, the amount subtracted from the policyholders surplus account by reason of such distribution shall be taken into account in determining life insurance company taxable income under section 802(b).

(b) Priority system for distributions to shareholders. (1) For purposes of section 815 (other than subsection (e) thereof relating to certain mutualizations) and section 802(b)(3) (relating to the determination of life insurance company taxable income), any distribution made to shareholders after December 31, 1958, shall be treated in the following manner:

(i) Distributions shall be treated as first being made out of the shareholders surplus account (as defined in section 815(b) and § 1.815-3);

(ii) Once the shareholders surplus account has been reduced to zero, distributions shall then be treated as

being made out of the policyholders surplus account (as defined in section 815(c) and § 1.815-4) until that account has been reduced to zero; and

(iii) Finally, any distributions in excess of the amounts in the shareholders surplus account and the policyholders surplus account shall be treated as being made out of other accounts (as defined in § 1.815-5).

(2) For purposes of subparagraph (1) of this paragraph, in order to determine whether a distribution (or any portion thereof) shall be treated as being made out of the shareholders surplus account, policyholders surplus account, or other accounts, the amount in such accounts at the end of any taxable year shall be the cumulative balance in such accounts at the end of the taxable year, computed without diminution by reason of a distribution (or any portion thereof) during the taxable year which is treated as being made out of such accounts. For example, on January 1, 1960, S, a stock life insurance company, had $1,000 in its shareholders surplus account and $3,000 in its policyholders surplus account. On November 1, 1960, S distributed $4,000 to its shareholders. Under the provisions of section 815(b)(2) and paragraph (b) of § 1.815-3, S added $5,000 to its shareholders surplus account for the taxable year 1960. Since the distributions to shareholders during the taxable year 1960, $4,000, does not exceed the cumulative balance in the shareholders surplus account at the end of the taxable year, computed without diminution by reason of distributions treated as made out of such account during the taxable year, $6,000 ($1,000 plus $5,000), the entire distribution is treated as being made out of the shareholders surplus account.

(3) Except in the case of a distribution in cash and as otherwise provided herein, the amount to be charged to the special surplus accounts referred to in subparagraph (1) of this paragraph with respect to any distributions to shareholders (as defined in section 815(a) and paragraph (c) of this section) shall be the fair market value of the property distributed, determined as of the date of distribution. However, for the amount of the adjustment to earnings and profits reflecting such distributions, see section 312 and the regulations thereunder. For a special rule relating to the determination of the amount to be charged to such special surplus accounts in the case of a distribution by a foreign life insurance company carrying on a life insurance business within the United States, see section 819(c)(1) and the regulations thereunder.

(c) Distributions to shareholders defined. (1) Except as otherwise provided in section 815(f) and subparagraph (2) of this paragraph, the term "distribution", as used in section 815(a) and paragraph (b) of this section, means any distribution of property made by a life insurance company to its shareholders. For purposes of the preceding sentence, the term "property" means any property (including money, securities, and indebtedness to the company) other than stock, or rights to acquire stock, in the company making the distribution. Thus, for example, the term includes a distribution which is considered a dividend under section 316, but is not limited to the extent that such distribution must be made out of the accumulated or current earnings and profits of the company making the distribution. For example, except as otherwise provided in section 815(f) and subparagraph

(2) of this paragraph, there is a distribution within the meaning of this paragraph in any case in which a corporation acquires the stock of a shareholder in exchange for property in a redemption treated as a distribution in exchange for stock under section 302(a) or treated as a distribution of property under section 302(d). For special rules relating to distributions to shareholders in acquisition of stock pursuant to a plan of mutualization, see section 815(e) and paragraph (e) of § 1.815-6.

(2) The term "distribution", as used in section 815(a) and paragraph (b) of this section, does not (except for purposes of section 815(a)(3) and (e)(2)(B)) include any distribution in redemption of stock issued prior to January 1, 1958, where such stock was at all times on and after the date of its issuance and on and before the date of its redemption limited as to the amount of dividends payable and was callable, at the option of the issuer, at a price not in excess of 105 percent of the sum of its issue price plus the amount of contribution to surplus (if any) made by the original purchaser at the time of his purchase.

[T.D. 6535, 26 FR 542, Jan. 20, 1961, as amended by T.D. 7189, 37 FR 12793, June 29, 1972]